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REVIEW OF CURRENT INVESTIGATIONS AND REGULATORY ACTIONS REGARDING THE MUTUAL FUND INDUSTRY

S. HRG. 108–711

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HEARINGS

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED EIGHTH CONGRESS

FIRST AND SECOND SESSION

ON

INVESTIGATIONS AND REGULATORY ACTIONS REGARDING THE MUTUAL FUND INDUSTRY AND INVESTORS' PROTECTION

NOVEMBER 18, 20, 2003, FEBRUARY 25, 26, MARCH 2, 10, 23, 31, AND APRIL 8, 2004

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

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REVIEW OF CURRENT INVESTIGATIONS AND REGULATORY ACTIONS REGARDING THE MUTUAL FUND INDUSTRY

TUESDAY, NOVEMBER 18, 2003

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10 a.m. in room SD–538 of the Dirksen Senate Office Building, Senator Richard C. Shelby (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN RICHARD C. SHELBY

Chairman SHELBY. The hearing shall come to order.

This hearing is part of the Committee's ongoing oversight of the mutual fund industry. Today, the Committee will review current investigations and enforcement proceedings and examine regulatory actions taken to date in order to fully inform and guide the Banking Committee's consideration of possible legislative reform.

On September 30, 2003, this Committee first examined the scope of problems confronting the mutual fund industry. At that time, Chairman Donaldson testified about the SEC's ongoing enforcement actions and described the SEC's regulatory blueprint for adopting new regulations aimed at improving the transparency of fund operations and stopping abusive trading practices. Since Chairman Donaldson's testimony, we have learned that improper fund trading practices are a widespread problem that fund insiders, brokers, and privileged clients have profited from at the expense of average investors.

In early September, New York Attorney General Spitzer uncovered arrangements through which brokers facilitated improper trades for their clients in certain prominent mutual funds in exchange for large, fee generating investments. Since this initial settlement, we have learned the extent to which both intermediaries, such as brokers, and fund executives have engaged in illicit trading activities. We have read about the backhanded ways by which the brokers colluded with their customers to disguise improper trade orders to make them appear legitimate, thus evading detection by mutual fund policing systems.

Even in situations where mutual funds attempted to halt improper trading activity, certain brokers created fictitious names and account numbers to fool fund compliance officers and to continue trading. Recent investigations have also revealed that mutual fund executives and portfolio managers have actively engaged in

improper trading activity. And these allegations are particularly troubling because fund executives and portfolio managers have represented themselves as protecting client assets, but they failed by either knowingly permitting improper trading by brokers or actively engaging in illegal trading activities themselves.

Such practices may not only violate prospectus disclosures, but also violate the fiduciary duties that funds owe to their shareholders—the duties to treat all shareholders equitably and to protect shareholder interests. Further, regulators have indicated that they may soon file charges against funds that have selectively disclosed portfolio information to certain privileged investors and fund executives that may have engaged in illegal insider trading by acting on the basis of nonpublic information.

As this Committee made clear during Chairman William H. Donaldson's September 30 appearance here, a regulatory response to improper trading activities is just one of the many actions that the SEC must take to address the many troubling issues that have come to light in the mutual fund industry. This Committee remains concerned with the transparency of fund operations and ensuring that investors can learn how their fund is being managed. It has become very, very apparent that many of the questionable fund practices that are now being examined are not just the result of a few bad actors, but are longstanding industry practices that have largely gone unregulated and not well disclosed to, or understood by, most investors.

Therefore, this Committee must take a comprehensive look, I believe, at the industry to determine if the industry's operations and practices are consistent with investors' interests and the greater interests of the market. It may be that we must consider possible realignment of interests to ensure that mutual funds are operating as efficiently and fairly as the market and investors demand. We will examine fund disclosure practices regarding fees, trading costs, sales commissions, and portfolio holdings. So, we will continue to question the conflicts of interest surrounding the relationship between the investment adviser and the fund and how potential changes to fund governance and disclosure practices may minimize these conflicts.

We will also focus on fund sales practices to ensure that brokers sell suitable investments to their clients, provide adequate disclosure of any sales incentives, and give clients any breakpoint discounts to which they are entitled.

Chairman Donaldson has told this Committee that the SEC has the necessary statutory authority to reform the mutual fund industry and is in the process of conducting a comprehensive rulemaking. As we have learned in other contexts, however, additional regulation is not the only answer. Late trading is clearly illegal and market timing is actively deterred and policed. Despite prohibitions and warnings, these activities continued unabated because of the inadequate compliance and enforcement regimes at the SEC, the mutual funds and the brokers. Whether due to a lack of resources or other pressing priorities, mutual fund abuses simply did not receive adequate attention from the SEC. Although recent enforcement actions indicate that priorities have changed, we need to

understand how the SEC will revise compliance programs to detect and halt future fund abuses.

Vigorous enforcement remains the key to restoring integrity to the fund industry, and Attorney General Spitzer's timely actions once again demonstrate, I believe, the significant role that States play in prosecuting fraud and abuse in the securities markets. Regardless of the number of rules or amount of resources, it would be impractical to expect the SEC to detect every single fraud and manipulation in the fund industry. Therefore, the mutual funds and the brokerage houses themselves must proactively adopt new compliance measures to detect fraud and abuse. For many years, participants in the mutual fund industry maintain industry "best practices." These practices, however, have clearly proven to be inadequate as brokers and funds have disregarded conflicts of interest and colluded at the expense of investors without detection. Although funds and brokers owe different types of duties to their investors, both groups have an obligation to refrain from knowingly ignoring their clients' interests and profiting at their expense.

With over 95 million investors and $7 trillion—yes, $7 trillion—in assets, mutual funds have always been perceived as the safe investment option for average investors. America has become a Nation of investors, but there is no doubt that recent revelations about mutual funds have caused very many to question the perceived fairness of the industry. Many are surprised to learn that the mutual fund industry is plagued by the same conflict that was at the root of the Enron scandal and the global settlement—one set of profitable rules for insiders and another costly set for average investors.

Beyond the legal concepts of fiduciary duties and transparency, there is a more fundamental principle that should underlie the operation of the mutual fund industry and our securities markets in general.

This principle is that securities firms and mutual funds should not neglect investors' interests and knowingly profit at their expense. Until firms can demonstrate an ability to abide by this ideal, investors will not trust the markets, nor should they. In our own way, Congress, the SEC and regulators, and industry participants must collectively work to reform the mutual fund industry in order to restore investor confidence. I believe, we must reassure investors that mutual funds are a vehicle in which they can safely invest their money and not fall victim to financial schemes. The mutual fund industry is simply too important to too many Americans to do otherwise.

Examining the mutual fund industry is a priority for this Committee, and I look forward to working with my fellow Committee Members, especially Senators Enzi, Dodd, and Corzine, all of whom have already expressed significant interest in this issue.

Our first witness today is Chairman Bill Donaldson, and on the second panel we will hear from Matthew Fink, President of the Investment Company Institute, and Marc Lackritz, President of the Securities Industry Association.

Now, I will call on my Members.

Senator Sarbanes.

STATEMENT OF SENATOR PAUL S. SARBANES

Senator SARBANES. Thank you very much, Chairman Shelby, and Chairman Donaldson, we are pleased to welcome you back before the Committee.

Chairman Shelby, I want to thank you for scheduling this important and timely hearing, the first in a series of hearings on mutual funds the Committee will hold this Congress. We have a second one scheduled on Thursday afternoon, I believe.

Chairman SHELBY. That is right.

Senator SARBANES. As concerns mount through the country about unfair, improper, and illegal practices in the mutual fund industry, today's hearing gives us the opportunity to examine the status of current investigations and the regulation of the mutual fund industry. I also look forward to Thursday's hearing when we will hear from the Director of Enforcement at the SEC, Stephen Cutler, New York Attorney General Eliot Spitzer, and NASD Chairman and CEO Robert Glauber.

Already, as you have noted, Mr. Chairman, a number of Senators have indicated their intention to work on this issue or have introduced legislation, including on our own Committee, Senators Corzine and Dodd. I am well aware of the strong interests of Senator Enzi, Chairman of the Subcommittee on Securities, with this matter, and I look forward to working with all of them. I should also note the strong interest of Senators Fitzgerald, Lieberman, and Akaka on the Government Affairs Committee, where a hearing was held just a short while ago.

Chairman Shelby, I appreciate your undertaking hearings on this issue and your expressed interest to work with the Subcommittee and all Members of the full Committee, as you have consistently done in the past on many of the issues that have come before us.

Almost 100 million Americans, representing 54 million households—more than half of all U.S. households—own mutual funds. The funds have a total, as Chairman Shelby noted, of more than $7 trillion in assets. Millions of small investors—savers—entrust their investment decisions to fund managers who are not only more knowledgeable and experienced, but also, at least in theory, honest and fair. Many people have looked upon mutual funds as a reliable alternative to traditional savings accounts.

In the last few months, deeply disturbing practices involving a growing number of funds have come to light. The disclosures began with New York Attorney General Spitzer's announcement on September 3, 2003, that a hedge fund, Canary Capital Partners, had engaged in illegal trading involving "late trading" and "market timing." And every week since then, we have been getting additional disturbing revelations.

At the time of the Canary Capital Partners' settlement, Attorney General Spitzer said, "I think it is a near certainty that other mutual fund companies will be named as having participated in these types of improper trading activities." Unfortunately, his prediction has turned out to be all too accurate.

Chairman Donaldson said, on October 30, only a few weeks ago, "The market timing and late trading issues are quite widespread. We are still gathering data on this and we think it is more wide-

spread than we originally anticipated." Chairman Donaldson, we are looking forward to your update on these issues this morning.

The revelation of these mutual fund practices are eroding investor confidence in some firms in the mutual fund industry. For example, *The Wall Street Journal* reported on November 11, 2003, a week ago, that "Assets under management at Putnam Investments, the first firm charged in the mutual fund trading scandal, dropped $14 billion in the week ended Friday." At least five States reportedly have dropped Putnam Investments as the manager of their retirement accounts.

Just yesterday, the SEC announced a $50 million settlement with Morgan Stanley. The allegations in that particular case were that Morgan Stanley received incentives to push certain funds on investors instead of others, either through payments or through brokerage commissions that were paid in part to compensate the sale of funds.

As the Committee launches these hearings, we must determine whether new laws, new regulations, or more effective enforcement of existing laws, or all of the above are needed to address these problems. Areas that need thorough examination include: late trading; market timing; fund governance; conflicts of interest; investor awareness of fund fees; special incentives to sell proprietary funds; fund structure; selective disclosure of portfolio holdings; trading by fund insiders; breakpoint discounts; sales practices; portfolio turnover; the effectiveness of the current regulatory scheme, including whether sufficient coordination exists at the SEC between the Divisions of Inspections and Compliance, Investment Management, and Enforcement; and whether an additional regulatory organization or board for the mutual fund industry would be beneficial.

As we review these areas and others, we must ensure that managers of mutual funds and the broker-dealers that sell mutual funds are not profiting unfairly at the expense of their investors.

Mr. Chairman, I think the witnesses we are starting off with today are uniquely positioned to address these issues, and I look forward to their testimony this morning.

Chairman SHELBY. Senator Enzi.

STATEMENT OF SENATOR MICHAEL B. ENZI

Senator ENZI. Thank you, Chairman Shelby, and thank you for holding this hearing today.

During the past few months, I am not sure that a single day has passed without the abuses of the mutual fund industry appearing on the front pages of newspapers and being featured in television and radio interviews. The situation seems a little reminiscent of the scandals that led up to the passage of the Sarbanes-Oxley Act. You can tell there is a lot of interest by the number of Committee hearings that are being held by Committees of nonjurisdiction——

[Laughter.]

Senator ENZI. —as well as the number of bills being written both in the House and in the Senate to deal with this, even before extensive hearings have been held. I do hope that the same methodical, balanced process of hearings as with the accounting reform will be done on this issue.

The troubles with the securities industry also bear a strange resemblance to the troubles that faced the banking industry in the late 1980's and in the early 1990's. During the early and the mid-1980's, the banking industry encountered a sizzling economy and a set of banking regulators that was considerably weak. The banking industry took advantage of the situation, and our Nation was faced with one of the most severe banking crises since the Second World War.

In the late 1980's and the early 1990's, Congress passed a series of banking laws to give the banking regulators a much stronger regulatory scheme and enforcement authority to set the industry straight. Today, our banking system is very strong, and sound, and investor confidence in the primary banking business is high.

Today, the securities industry mimics the banking industry of the early 1990's. The securities industry, like their banking counterparts, took advantage of a very strong economy of the late 1990's and a weakness with the regulator. Law changes came. Last year, when accounting irregularities surfaced, we started with the passage of the Sarbanes-Oxley Act to restore investor confidence. It appears almost certain that legislation will be necessary to restore investor confidence in the mutual fund industry now.

The major difference that I would like to see in Congress' reaction to the crisis in the securities industry is to thoroughly evaluate the problem to find the right solution. One of the major problems that Congress had with passing several large pieces of legislation with the banking legislation in a relatively short period of time is today the banking industry may be overregulated, and that hurts community banks' ability to survive and to grow, and that is very important in the rural areas.

With respect to the securities industry, we should not rush to pass legislation, as we may do undue harm to the industry. However, we should take the approach that we used in the Sarbanes-Oxley Act. Typically, for every action, Congress has a tendency to overreact. In this situation, we need to thoroughly review the problems to find the right solution. We know that the legislation that we pass is never perfect. With the Sarbanes-Oxley Act, we are still trying to be careful of the cascading effect that it can have on small entities.

There may be unintended consequences to solutions that we now consider for mutual funds. Currently, the SEC has the authority under existing law to handle the late trading and timing issues. There is a record trail of all of these transactions. What needs to be done is to adjust the current regulatory scheme and to have greater enforcement of those rules.

I welcome Chairman Donaldson here yet again. We thank you for appearing before the Committee. I know this has been a hectic year for you, and hopefully with the passage of laws to increase the appropriations and the hiring authority for the SEC, we have made the SEC much stronger. The examination and enforcement arms of the SEC are in need of greater assistance.

Again, I thank the Chairman for holding this hearing.

Chairman SHELBY. Senator Reed.

STATEMENT OF SENATOR JACK REED

Senator REED. Thank you very much, Chairman Shelby, and I welcome Commissioner Donaldson.

I want to thank Chairman Shelby for holding this important and timely hearing, and I hope that we will use this as an opportunity for a thoughtful discussion on effective and aggressive enforcement and also to continue to encourage all of the regulators—the SEC, the Nasdaq, and the Attorney General—to work collaboratively to punish the wrongdoers.

The behavior we have observed represents a profound breach of trust, and ultimately all markets rest on a foundation of trust. So this is not merely an example of technical problems; these very well could be existential problems if we do not move rapidly, aggressively and effectively, and I hope we can do that.

There are approximately 8,200 mutual funds with over $7 trillion in assets. Thirty-eight percent of those assets come from 401(k)s. To many investors, mutual funds or for professional advisers, instant diversification, liquidity and a wide range of investment choices, and the advantages of mutual funds would be hard to achieve for the small investor on his or her own.

However, with these daily revelations of wrongdoing by some of the most reputable mutual fund companies, by allowing the favored investors to take advantage of rank and file, it is very clear that average investors are becoming increasingly worried about their financial futures.

There was an article in last Sunday's *New York Times* that said it well: "Employees saving for retirement cannot seem to catch a break. After nearly 3 years of painful bear market losses, revelations of improper trading by insiders and a few favored investors began to raise fundamental questions about the trustworthiness of mutual fund managers."

And if we do not rapidly and effectively answer those questions about trustworthiness, then the market will be in a serious, serious predicament. I hope this hearing will go a long way to start responding to the concerns of the investing public and maintain the advantages of mutual funds without the trading that has discouraged people today from participating as they should.

Thank you, Mr. Chairman.

Chairman SHELBY. Senator Allard.

STATEMENT OF SENATOR WAYNE ALLARD

Senator ALLARD. Mr. Chairman, I would like to thank you for holding this important hearing, and I appreciate your special attention to this matter, as well as Senator Enzi, as we witnessed a disturbing amount of misconduct that apparently has overtaken the mutual fund industry in recent months.

I do not think anybody can dispute the fact that mutual funds are a vital part of the U.S. economy. The $7 trillion in assets is a substantial amount of money based on anybody's standards. When you look at the number of households that are participating in mutual funds, I think Senator Sarbanes mentioned something like 50 percent or so, and that is my understanding too. And households are using these dollars to meet the needs of the family. It is educational needs. It is retirement—especially retirement needs. That

is a big part—educational needs and in some cases to help afford a house.

So it is absolutely vital that we can assure people who are participating in mutual funds that it is a fair process and that it is something they can rely on for their future needs. In my view, all investors should be treated fairly, both the small investor, as well as the institutional investor. Recent events have proven that there is not equal access to the handling of mutual funds. In order for a fund to succeed and an investor to remain confident in his or her investment, all aspects of the mutual fund business must be as transparent as possible.

Investors need to be able to have confidence in their fund managers and know that their money is not being manipulated by the manager. Therefore, investors need to be able to have confidence that there are not other investors who have privileged access to the handling of the mutual fund.

Again, I would like to thank Chairman Donaldson for coming before the Committee today to discuss the ways the Commission can enhance the protection of the investor rights and prevent the abuses that have seemingly become widespread.

I would also like to thank Mr. Fink and Mr. Lackritz for taking the time to be here today, and I look forward to their testimony, Mr. Chairman.

Chairman SHELBY. Thank you, Senator Allard.

Senator Corzine.

STATEMENT OF SENATOR JON S. CORZINE

Senator CORZINE. Thank you, Mr. Chairman, and I appreciate you holding the hearings and beginning this process of examining both the issues and potential responses that we should be taking to deal with a problem that is very real. I welcome the Chairman as well. It has been an incredible year for you.

Mutual funds, as all of us know, are a fundamental vehicle for investors to participate in America's capital markets, not just the equity markets, but also bond, real estate, and a whole series of assets. And we have heard that 95 million Americans invest nearly $7 trillion. This is really key and a cornerstone of the success of capital formation and savings in this country.

The industry, which is one of our oldest, and at least from my perspective and understanding until recently, really one of the most respected industries, entrusted by those 95 million shareholders, and I think, for the most part, has done well in promoting those dreams and retirement and ability to pay a child's college tuition, buy a home, all of the things that we talked about.

But it is quite clear that, in recent times, our mutual fund industry has moved away from some of those long traditions that I think have been a part of it, and it has been brought on by many individuals, their own actions, their own sense of excess, and some would even say greed. It started out as an investigation at the behest of whistleblowers to the New York State Attorney General's Office and has become really, I think, one of the underlying most serious scandals we have in the history of any marketplace, from my view, given the broad retail participation, small investor participation that goes on here.

I am not going to go through the laundry list of issues. We have talked about them. I do think we need a very serious, thoughtful, not overreaching response, but one that restores the confidence of investors and participants in this market and needs to be done in a relatively expeditious manner.

As the Chairman noted and others, Senator Dodd and I just announced a plan to introduce legislation at the end of this Committee's series of hearings on the mutual fund industry. We have laid out a number of the points of outline with regard to governance, and disclosure, and fund governance, and I think that action will be needed if we want to see what is an extraordinary asset in America's financial system to continue to prosper. And if we want to see capital formation in this country prosper in a way that I think makes us unique in the developed world, we need to get a handle on this and move relatively quickly.

I thank the Chairman and I am looking forward to hearing the remarks not only of Chairman Donaldson, but also of the other witnesses as well.

Chairman SHELBY. Senator Bayh.

STATEMENT OF SENATOR EVAN BAYH

Senator BAYH. I thank the Chairman, and I want to thank the Committee for conducting this hearing today. You know a subject is topical when we have a literally standing room only crowd in the hearing room. So, I thank you for focusing on a matter of such importance.

Chairman Donaldson, thank you for your diligent efforts these last 9 months to get on top of some very difficult problems. I am tempted to ask if you have had any buyer's remorse since accepting this appointment. We thank you for your public service.

This is critically important because it affects the continued democratization of our capital markets, which has been one of the great trends in American free enterprise over the last several decades. It would be truly unfortunate if average Americans concluded that the only safe place for their savings was back in the mattress once again, rather than in financial instruments on which they could rely. Such a conclusion would be harmful to our economy. It would be harmful to them. So it is this basic trust that convinces ordinary Americans that they can invest with confidence that we address here today.

In my own State, Senator Corzine and others have mentioned the 95 million shareholders, we have 2.1 million mutual fund shareholders just in the State of Indiana. So this is a matter of great significance to ordinary people across the heartland of the country, and we look forward to hearing from you about that today.

My colleagues have touched upon a variety of topics—two others I would throw out, starting with I hope at some point, either in response to questions or in your testimony you can address what can ordinary Americans do, what are ordinary investors to think? I suspect a lot of what we will talk about here today will sound like we are speaking in Chinese to them, but in layman's terms, what can they do to protect themselves? How can they be intelligent participants in the investing marketplace and seek out vehicles on which they can rely? What should they look at in terms of the companies

in which they invest? To the extent that you can address that, I think it would be very helpful to empowering investors to protect themselves.

Second, as a former Chief Enforcement Officer of my own State, in terms of the securities laws, I am curious as to what you perceive to be the appropriate balance, in terms of jurisdictional responsibilities, between the Federal Government and the States, the SEC and the various State authorities assigned to protect ordinary investors from potential abuses? That has been a matter of some controversy of late, particularly with regard to the Putnam issue, which I understand Senator Sarbanes mentioned. So if you could perhaps discuss what in your view is the appropriate balance of jurisdiction between the Federal and State authorities, I think that could be very helpful.

I, again, commend you for your efforts and thank you for taking the time to be here today.

Thank you, Mr. Chairman.

Chairman SHELBY. Senator Dodd.

STATEMENT OF SENATOR CHRISTOPHER J. DODD

Senator DODD. Thank you very much, Mr. Chairman, and welcome, Chairman Donaldson of the SEC. It is good to have you here before the Committee again.

First of all, let me thank the Chairman of the SEC. You are going to be appearing a couple of times this week, both on this issue and on corporate governance issues. We appreciate your being here before the Committee.

Chairman Shelby, let me thank you as well. The hearing today and the hearing I guess on Thursday that we will be conducting is very timely and important. With all we have going on, there is a lot on our agenda this week. This is truly a critical issue, I appreciate the leadership of you, Chairman Shelby, and Senator Sarbanes on making this a matter before the Committee.

Just a couple of points. I presume some of these things have been mentioned already by my colleagues. Obviously, the volume, the number of Americans who seek out mutual funds as a way of producing wealth and also providing long-term financial security for themselves has been well documented. It is critically important that we not take this remarkable success story, which mutual funds have been, and have them, in some way, have people start to flee from them. I am sure all of us share that common thought. It is hard these days not to pick up the newspaper and find yet another story of another fund that has had some serious problems.

My colleague from New Jersey has already mentioned the fact that he and I have at least put together some ideas as a bill, which we will be interested in your comments on, what you think of what we have suggested. It is rather lengthy in its nature. It covers about four major areas, in the area of governance, and cost, and oversight and the like. So, we would be very interested in the comments of the SEC on it.

I respect as well the work that is being done by Senator Akaka, my colleague, Senator Lieberman, I think has legislation in, as well as Congressman Baker and Congressman Oxley as well are moving on legislation. So there are some legislative vehicles that are mov-

ing through the Congress, and it seems to me we should try and respond to those if, in fact, that is appropriate.

There are obviously some fundamental changes I think that are going to be needed in the way of funds and how they are governed, and I would like to hear your thoughts on that and your testimony.

The widening gap between what investors believe mutual funds cost and the actual cost is one of the areas that we have addressed very strongly in our proposed legislation, and I would be interested in your thoughts there as well and looking at the current oversight of the industry.

Finally, I would say to you here obviously restoring confidence in the mutual fund industry is important. What also is important—and I know you share this thought—is restoring confidence in the SEC as well. I appreciate the article, the op-ed piece that you wrote. But it is very important that we get in front of this so that people will understand that the "cop on the beat," as well as the policy-setters, if you will, here are in tandem.

Let me underscore the comment that was made by Senator Bayh as well. We need to get to the point where between what is going on in the States—and we are going to hear from Eliot Spitzer later this week—there are other attorneys general around the country that are moving in this area, and I think in order to try and not have this become more confusing for people to try and see to it that we are coordinating these activities. And that should not be one level of Government competing with another on this issue. We all should be heading in the same direction, rowing in the same direction, and I hope that is an issue we can address as well.

So with that, Mr. Chairman, I thank you.

Chairman SHELBY. Now, Mr. Chairman, your written testimony will be made part of the record in its entirety. You may proceed as you wish.

STATEMENT OF WILLIAM H. DONALDSON
CHAIRMAN
U.S. SECURITIES AND EXCHANGE COMMISSION

Chairman DONALDSON. Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee, thank you for inviting me to testify on the Securities and Exchange Commission's initiatives to address problems in the mutual fund and brokerage industry. When I testified before you on September 30, the discovery of late trading and market timing abuses by personnel at the hedge fund Canary Capital had just erupted. I will update you on recent developments since then. First, though, I would like to share with you the fundamental rights that I believe every mutual fund investor not only should expect, but also to which every investor is entitled. We all—regulators, legislators, the brokerage and mutual fund industry, the financial press and investors themselves—have spent much time lately wondering how the current abuses could have happened. I believe that a significant reason is because the industry lost sight of certain fundamental principles—including its responsibilities to the millions of people who entrusted their confidence, the fruits of their labor, their hopes and their dreams for the future to this industry for safekeeping. These investors are entitled to honest and industrious fiduciaries who sensibly put their

money to work for them in our capital markets. No one can argue with the fact that investors deserve a brokerage and mutual fund industry built on fundamentally fair and ethical legal principles.

Let me just briefly outline these rights, as I see them, and the critical initiatives underway at the Commission to ensure that enhanced and crucial investor protections deriving from these rights are put in place as quickly as possible.

First, mutual fund investors have a right to an investment industry that is committed to the highest ethical standards and that places investors' interests first. Every brokerage and mutual fund firm needs to conduct a fundamental assessment of its obligations to its customers and shareholders. These assessments must be put forth at the highest levels, and implemented so as to reach all employees. Senior management and the boards of directors must be ready to lay down and vigorously enforce rules that define an immutable code of conduct.

Second, investors have a right to equal and fair treatment by their mutual funds and brokers. Our examinations and investigations of late trading and market timing abuses have revealed instances of special deals and preferential treatment being afforded to large investors, often to the detriment of small investors. The concepts of equal and fair treatment of all investors and the prohibition against using unfair informational advantages are embedded in various provisions of the Federal securities laws, including the Investment Company Act. The SEC will not tolerate arrangements of this kind that violate these fundamental principles.

Third, investors have a right to expect fund managers and broker-dealers to honor their obligations to investors in managing and selling funds. Our examinations and investigations into the current abuses have revealed instances of fund managers placing their interests—and in the case of some portfolio managers, placing their personal interests—ahead of those of fund investors. We have also seen recent examples of abusive activity by broker-dealers and their representatives in connection with the sale of fund shares, including failure to give investors the breakpoint discounts to which they are entitled, recommendations that investors purchase one class of shares over another in order for the salesperson to receive higher compensation and other sales practice abuses. This cannot be and will not be tolerated.

Fourth, investors have a right to the assurances that fund assets are being used strictly for their benefit. Clearly, fund assets, including the use of a fund's brokerage commissions, must be used in a manner that benefits fund investors. The Commission must engage in a reassessment of how fund commission dollars are used, including various soft-dollar arrangements and the lack of transparency to investors of these payments.

Fifth, investors have the right to clear disclosure of fees, expenses, conflicts, and other important information. Mutual fund investors must have the tools and the information to make intelligent investment decisions. To that end, the Commission will take action to enhance disclosure to fund investors of fees and expenses, and the conflicts that arise as a result of the various arrangements between funds and brokers regarding the sale of fund shares, as well as other important information.

Sixth, investors have a right to independent, effective boards of directors who are committed to protecting investors' interests. Investors need to be assured that their mutual fund directors have the independence and commitment necessary to carry out this crucial function. We are proposing to set enhanced standards for board independence and are considering other steps in this area.

Seventh, investors have a right to effective and comprehensive mutual fund and broker compliance programs. Programs designed to ensure compliance with the Federal securities laws are an essential tool in the protection of investors. Fund investors need to be assured that all funds, advisers, and selling brokers have internal programs to ensure compliance with the Federal securities law. We will complete our pending rulemaking to strengthen procedures at mutual funds and advisers.

Eighth, investors should expect that aggressive enforcement actions will be taken when there are violations of the Federal securities laws. We will continue to take strong and appropriate action against those who violate the Federal securities laws. So there will be serious consequences to those who violate the law. Wherever appropriate, we will ensure that investors receive restitution.

By holding the industry—and I might add ourselves—to these standards, we can significantly minimize the possibility of future scandals that harm millions of mutual fund investors, and hopefully restore their confidence in the industry.

Now let me just outline specific initiatives to ensure that the mutual fund investors' rights that I have outlined are realized.

For too long, the Commission has found itself in a position of reacting to market problems, rather than anticipating them. There are countless reasons for this—not the least of which include historically lagging resources and structural and organizational roadblocks. The time for excuses has long passed.

Since the President nominated me to the Commission in February, one of my top priorities has been to reevaluate and determine how the Commission deals with risk. Part of this evaluation has been a thorough review of the Commission's internal structure. The results of our work form the basis for a new risk management initiative that will better enable the Commission to anticipate, identify, and manage emerging risks and market trends that stand to threaten the Commission's ability to fulfill its mission.

This critical initiative—the first of its kind at the Commission—will enable us to analyze risk across divisional boundaries, focusing on early identification of new or resurgent forms of fraudulent, illegal, or questionable behavior or products. Operating under the "Doctrine of No Surprises," this initiative seeks to ensure that senior management at the Commission has the information necessary to make better, more informed decisions.

The new initiative will be housed within a newly created Office of Risk Assessment, and will be headed by a director who reports directly to the Chairman. The director will coordinate and manage risk assessment activities across the agency, and will oversee a staff of five professionals, who will focus on the key programmatic areas of the agency's mission.

The duties of the Office of Risk Assessment will be focused on the following areas: Gathering and maintaining data on new trends

and risks from a variety of sources—including external experts, domestic and foreign agencies, surveys, focus groups, and other market data, including both buy-side and sell-side research. Analyzing data to identify and to assess new areas of concern across professions, companies, industries, and markets. Preparing assessments and forecasts on the agency's overall risk environment.

The work of the Office of Risk Assessment will be complemented by a Risk Management Committee. Additionally, each division and major office will have one-to-two risk assessment professionals on staff, who will work closely with the division director or office head as a part of the risk management teams.

I believe this important initiative will fundamentally change the way the Commission assesses risk and help us, I hope, head off major problems before they occur.

In addition to fundamental changes in risk assessment, I have ordered the Division of Enforcement to enhance its existing mechanism and processes for handling complaints. In particular, the process of receiving, analyzing, and responding to all public tips has been streamlined and standardized. We receive approximately 1,000 complaints and tips every day. We are upgrading our system for handling these inputs to ensure that each one—regardless of where it comes from, how it comes to us, via phone, Internet, or e-mail—is analyzed, clearly logged detailing the nature of the complaint or tip, when it was received and how it was handled or disposed of by the SEC staff. To ensure speedy and appropriate disposition of each tip or complaint, a senior manager will review the log on a regular and frequent basis.

Now as to late trading and market timing abuses—late trading and market timing abuses represent the most recent violations against investors' rights. In addition to those abuses, we have seen other violations of investors' rights, including, to name but a few, violations of an investors' right to high ethical standards, fiduciary protections, clear disclosure, and equal treatment. While we are vigorously pursuing enforcement actions regarding this misconduct, we are also taking a number of regulatory steps immediately to deal specifically with these abuses.

On December 3, the Commission will consider a package of reforms to combat late trading and market timing abuses. The package includes the staff's proposal requiring that a fund or certain designated agents—rather than an intermediary such as a broker-dealer or other unregulated third party—receives a purchase or redemption order prior to the time the fund prices its shares, which is typically 4 p.m. Eastern Standard Time, for an investor to receive that day's price. This "hard" 4 o'clock cutoff would effectively eliminate the potential for late trading through intermediaries that sell fund shares.

With respect to market timing abuses, the Commission will consider requiring additional, more explicit disclosure in fund offering documents of market timing policies and procedures. This disclosure would enable investors to assess a fund's market timing practices and determine if they are in line with their expectations.

The staff's recommendations will have a further component of requiring funds to have specific procedures to comply with the representations regarding market timing policies. While our exam-

ination staff will use a variety of techniques to police for market timing abuses, the establishment of formal procedures will also enable the Commission's examination staff to review whether those procedures are being followed and whether the fund is living up to its representations. The Commission also will emphasize the obligation of funds to fair value their securities so as to avoid "stale pricing" to minimize market timing arbitrage opportunities as an important additional measure to combat market timing activity.

Also on December 3, the Commission will consider adoption of new rules under the Investment Company Act and the Investment Advisers Act that will ensure that mutual funds have strong compliance programs. Specifically, the rules that the Commission will consider would require each investment company and investment adviser registered with the Commission to: One, adopt and implement written policies and procedures reasonably designed to detect and to prevent violations of the Federal securities law. Two, review these policies and procedures annually for their adequacy and their effectiveness. Three, designate a chief compliance officer to be responsible for administering the policies and procedures and to report directly to the fund's board of directors. A chief compliance officer reporting to the fund's board of directors will strengthen the hand of the fund's board and compliance personnel in dealing with fund management.

Allegations of certain portfolio managers market timing the funds they manage or other funds in the fund complex raise issues regarding self-dealing. Recent allegations also indicate that some fund managers may be selectively disclosing their portfolios in order to curry favor with large investors. Selective disclosure of a fund's portfolio can facilitate fraud and have severely adverse ramifications for the fund's investors. You can expect that these issues will also be addressed in the rulemaking recommendations that the Commission will consider on December 3.

The package of reforms that I have just outlined for you is designed to provide immediate reassurances and protection to mutual fund investors, but we cannot stop there. We will explore the full range of our authority, not only in the reforms discussed, but also in additional areas to further address market timing abuses.

For instance, while the Commission's actions regarding fair value pricing should address the problem of stale pricing, which facilitates market timing, we will consider more in this area. As such, I have asked the staff to study additional measures for Commission consideration, including a mandatory redemption fee imposed on short-term traders and developing a solution to the problem of trading through omnibus accounts.

Let me just touch on omnibus accounts for a minute. Trading through omnibus accounts, which are accounts held at intermediaries, such as broker-dealers, often means that mutual funds do not have the information on the identity of the underlying brokerage customer who is purchasing or redeeming the fund shares. This can make it difficult for funds to assess redemption fees, limit exchanges, or even kick out a shareholder who is market timing through an omnibus account because they just do not know the identity of that shareholder.

To assist the staff as it moves forward in considering this issue, I have called upon the NASD to head an Omnibus Account Task Force consisting of members of the fund and brokerage industries, as well as other intermediaries to further discuss and study this issue and to provide the SEC staff with information and recommendations. Under the NASD's capable leadership, I am confident that working with the NASD and the industry, we will be able to develop a proposal that will adequately address the omnibus account issue, which is complicated.

I also anticipate reforms in the area of fund governance. The statutory framework governing mutual funds envisions a key role for boards of directors in light of the external management structure typical for funds. The directors, particularly "independent directors," are responsible for managing conflicts of interest and representing the interests of shareholders.

I believe we need to improve and enhance the independence of fund directors, and there are a number of ideas for reforms including, but not limited to: Requiring an independent chairman of the fund's board of directors. Increasing the percentage of independent directors under SEC rules from a majority to three-quarters. Providing the independent directors the authority to retain staff as they deem necessary so that they do not have to necessarily rely on the fund's adviser for assistance. Requiring boards of directors to perform an annual self-evaluation of their effectiveness, including consideration of the number of funds they oversee and the board's committee structure; and adopting a rule that would require boards to focus on and preserve documents and information that directors use to determine the reasonableness of fees relative to performance, quality of the service and stated objectives, including a focus on the need for breakpoints or reductions in advisory fees and comparisons with fees and services charged to other clients of the adviser.

I have also called upon the fund independent directors themselves to be active participants in the reform effort. Specifically, I have asked former SEC Chairman David Ruder's nonprofit mutual fund director's organization, the Mutual Fund Directors Forum, which is geared toward independent mutual fund directors, to develop guidance and best practices in key areas of director decisionmaking, such as monitoring fees and conflicts, overseeing compliance, and important issues such as evaluation and pricing of fund portfolio securities.

Another fundamental right of mutual fund investors is clear, easy-to-understand disclosure, including disclosure of the fees and expenses they pay. I anticipate that in January the Commission will consider the adoption of rules that will require actual dollars-and-cents fee disclosure to shareholders, coupled with more frequent disclosure of portfolio holdings information; this would allow investors to determine not only the fees and expenses they are paying for their particular funds and would also greatly facilitate comparison among different funds. We also want to provide investors better information on portfolio transaction costs so that they can factor this into their decisionmaking. Consequently, the staff is developing for Commission consideration in December a concept

release to solicit views on how the Commission should proceed in fashioning disclosure of these costs.

Investors deserve to know what fees and expenses their fund pays, and they also deserve to know how much their broker stands to benefit himself or herself from the purchase of a particular fund.

Thus, we also plan to improve disclosure about mutual fund transaction costs through confirmations that broker-dealers provide to their customers. I have directed the staff to prepare for Commission consideration, by the end of this year, a new mutual fund confirmation statement that will provide customers with quantified information about the sales loads and other charges that they incur when they purchase mutual funds with sales loads.

Additionally, the staff will consider similar disclosures which will provide more information to investors at the point of sale. To address an investor's right to know about conflicts of interest that brokers may have when selling fund shares, the new mutual fund confirmation statement also will include specific disclosures regarding revenue sharing arrangements, differential compensation for proprietary funds and other incentives, such as Commission business for brokers to sell fund shares that may not be readily apparent to fund investors.

To ensure that investors receive the benefits of fund assets to which they are entitled, the Commission will examine how brokerage commissions are being used to facilitate the sale and distribution of fund shares, as well as the use of soft-dollar programs.

I have also instructed the staff to consider rules that would better highlight for investors the basis upon which directors have approved management and other fees of the fund.

The Commission long has recognized the importance of strong internal controls and will continue to explore additional approaches the Commission might pursue to require funds to assume a greater responsibility for compliance with the Federal securities laws, including whether funds and advisers should periodically undergo an independent third-party compliance audit. These compliance audits could be a useful supplement to our own examination program and could ensure more frequent examination of the funds and advisers.

In addition to ensuring the funds' shareholders receive their fundamental rights, we also have to ensure effective enforcement of those rights and of the Federal securities law. Steve Cutler, the SEC's Director of Enforcement, will be testifying before you on our enforcement efforts Thursday, I believe, and he can answer your specific questions about the Commission's enforcement actions, as well as the results so far in our ongoing investigations.

Let me emphasize, however, that I am appalled at the types and extent of conduct that is being revealed in our examinations and investigations. It is conduct that represents fundamental breaches of fiduciary obligations and betrayal of our Nation's investors. I can assure you we are committed to seeking redress for investors and meting out the appropriate punishment in these matters to send a strong message that these types of abuses will not be tolerated.

Now if you will let me go for a couple of more minutes——

Chairman SHELBY. Go ahead, Mr. Chairman.

Chairman DONALDSON. Let me just touch on, and I realize I have been talking far too long.

Chairman SHELBY. Take your time.

Senator SARBANES. No, no. You should take all of the time you need to fully present this.

Chairman SHELBY. Absolutely. It is important.

Senator SARBANES. This is very important, and we need to know what the SEC has in focus.

Chairman SHELBY. Chairman, we are not rushing you at all. We have all day.

Chairman DONALDSON. Thanks.

Senator DODD. To a point—this is not a filibuster. We just went through that.

[Laughter.]

Chairman DONALDSON. I want to discuss, briefly, last week's settlement of charges against Putnam relating to allegations of market-timing trades by certain Putnam employees. Among its many roles, the Securities and Exchange Commission has, in my view, two critical missions. The first is to protect investors, and the second is to punish those who violate our securities laws. Last week's partial settlement of the SEC's fraud case against the Putnam mutual fund complex does both. It offers immediate and significant protections for Putnam's current mutual fund investors. Moreover, by its terms, it enhances our ability to obtain meaningful financial sanctions against the alleged wrongdoing at Putnam and leaves the door wide open for further inquiry and regulatory action. And I want to emphasize that.

Despite its merits, the settlement has provoked considerable discussion, and some criticism. Unfortunately, in my view, the criticism is misguided and misinformed, and it obscures the settlement's fundamental significance.

By acting quickly, the SEC required Putnam to agree to terms that produce immediate and lasting benefits for investors currently holding Putnam funds. First, we put in place a process for Putnam to make full restitution for the investor losses associated with Putnam's misconduct. Second, we required Putnam to admit its violations for purposes of seeking a penalty and other monetary relief—an important point. And third, we forced immediate, tangible reforms at Putnam to protect investors from this day forward. These reforms are already being put into place, and they are working to protect Putnam investors from the misconduct we found in this case.

Among the important reforms Putnam will implement is a requirement that Putnam employees who invest in Putnam funds hold those investments for at least 90 days, and in some cases for as long as a year, putting an end to the type of short-term trading we found at Putnam. On the corporate governance front, Putnam's fund boards of trustees will have independent chairmen, at least 75 percent of the board members will be independent, and all board actions will be approved by a majority or must be approved by a majority of the independent directors. In addition, the fund boards of trustees will have their own independent staff members who report to and assist the fund boards in monitoring Putnam's compliance with the Federal securities laws, its fiduciary obligations and duties to shareholders, and its Code of Ethics. Putnam has also committed to submit to an independent review of its policies and

procedures designed to prevent and detect problems in these critical areas—now, and every other year.

This settlement is not the end of the Commission's investigation of Putnam. If we turn up more evidence of illegal trading, or any other prohibited activity, including in the fee disclosure area, we will not hesitate to bring additional enforcement actions against Putnam or any of its employees.

Meanwhile, the Commission is already moving forward with rulemaking that will address fee disclosure issues, and others, on an industrywide basis. Those lacking rulemaking authority seem to want to shoehorn the consideration of fee disclosure issues into the settlement of lawsuits about other subjects. But we should not use the threat of civil or criminal prosecution to extract concessions that have nothing to do with the alleged violation of law that we are investigating.

Criticism of the Commission for moving too quickly, in my view, misses the significance of the Commission's action. While continuing our broader investigation of Putnam, we have reached a fair and far-reaching settlement that establishes substantial governance reforms and compliance controls that are already benefitting Putnam investors. It is a settlement where the Commission put the interests of investors first. As the Commission continues to initiate critical and immediate reforms of the mutual fund industry, and while we investigate a multitude of other cases involving mutual fund abuses, we will continue to seek reforms to provide immediate relief to harmed investors.

In the meantime, as I noted earlier, our investigation of Putnam is ongoing, active, and focused on market timing and related issues. We will not hesitate to take additional actions if other wrongdoing comes to light.

A few brief words on Morgan Stanley. I might note that just yesterday the Commission announced enforcement actions against Morgan Stanley arising out of the firm's mutual fund sales practices, a whole separate order of concern. Morgan Stanley has agreed to a settlement of the action that calls, in part, for it to pay a total of $50 million, all of which will be returned to investors. The action grows out of an investigation begun last spring.

Few things are more important to investors than receiving unbiased advice from their investment professionals. Morgan Stanley's customers were not informed of the extent to which Morgan Stanley was motivated to sell them a particular fund.

Our investigation also uncovered conflicts of interest in the sale of mutual funds at Morgan Stanley. This practice, which has been the subject of other Commission cases during the last several months, involves the sale of Class B mutual fund shares to investors who were more likely to have better overall returns if they bought Class A shares in the same funds.

The abuses that are addressed in this case are significant and not necessarily limited to Morgan Stanley. The Commission is conducting an examination sweep of some 15 different broker-dealers to determine exactly what payments are being made by the funds, the form of those payments, the "shelf space" benefits that the broker-dealers provide, and most importantly, just what these firms tell their investors about these practices. I also want to note

that the potential disclosure failures and breaches of trust are not limited to broker-dealers. We are also looking very closely at the mutual fund companies themselves.

Taken together, the reforms that the Commission has already undertaken, and those currently being initiated are both substantial and far-reaching. We have, and we will continue to put the needs of mutual fund investors first.

I appreciate the opportunity to share my views. I appreciate your patience in listening to them, and I would be happy to answer any questions you may have.

Thank you.

Chairman SHELBY. Mr. Chairman, we appreciate your comprehensive statement.

You brought up Putnam. Mr. Chairman, many people have criticized the SEC's recent settlement with Putnam for, among other things, failing to extract meaningful concessions from Putnam.

For example, the settlement, as I understand it, does not force Putnam to change its fee structure or to disgorge the management fees that it earned during the period of improper training. Some have stated that the SEC rushed, as you anticipated here in your statement, to settle the charges against Putnam and missed, Mr. Chairman, a significant opportunity to create a template for reforming the whole fund industry. Some have even suggested that the SEC set the standard so low for a settlement that many funds will hurry to get the same deal.

How do you respond to these criticisms? You alluded to them a minute ago. Is the Putnam settlement a model for the types of reform that the SEC is seeking? Why did you do it so quickly rather than trying to seek an industrywide settlement?

Chairman DONALDSON. Well, let me say several things.

First of all, it is important to understand what the case against Putnam was all about.

Chairman SHELBY. Sure.

Chairman DONALDSON. The case against Putnam was all about failure to supervise the alleged actions of individual employees, who were purchasing fund shares of the funds that they were managing, failure to super——

Chairman SHELBY. Is that all it was about?

Chairman DONALDSON. Second, fraud because they did not disclose this practice. The management company did not disclose the practice to the directors of the funds themselves. Those were the issues.

The issues of fees were not part of this settlement. They were not brought up, and I believe, as I tried to say, perhaps inarticulately, that these are other issues that need to be addressed as we find them, and when we find them, but we do not think that we should use a bludgeon at this time to bring in a whole lot of other reforms that may pertain to the rest of the industry or may just pertain to Putnam in this settlement.

We thought the higher good, if you will, was bringing these charges to a conclusion, and in so doing, to hopefully begin to eliminate immediately the burdens that are currently being placed on Putnam fund shareholders by the redemptions that are going on. Clearly, the redemptions that are going on, and having to set aside

money, and having to sell stocks, and so forth are causing an undue burden on existing shareholders; and we are very concerned, in the immediacy of this settlement, for those shareholders.

I will say again that we have ongoing investigations at Putnam in a number of areas.

Chairman SHELBY. Mr. Chairman, how many mutual funds do we have in the United States, roughly?

Chairman DONALDSON. There are all sorts of different figures on that. I think there are probably somewhere around 8,800 mutual funds in the country.

Chairman SHELBY. How many are you investigating here, 15, thus far?

Chairman DONALDSON. We immediately went out to 88 of the largest fund groups, and that—I cannot give you the exact figure—but that represented a substantial majority——

Chairman SHELBY. Of the money.

Chairman DONALDSON. —of the money in mutual funds. So, we are into those funds, and we have been questioning them. Our inspectors are out there.

Chairman SHELBY. But of the 15 you are looking at very closely, you have reason to believe that funny things have been going on there, do you not, more or less?

Chairman DONALDSON. Yes. When we originally went in with our inquiry, we felt that we found—not "feel" that we found—we found that upward of 50 percent of these funds had some special arrangements, that 30 percent had helped, in one way or another, with market timing, that 10 percent had helped with late trading, and that 30 percent disclosed details of their holdings. Those were our original survey. We are now back in there trying to put definitive facts on——

Chairman SHELBY. But this investigation is just beginning, is it not, into a lot of these?

Chairman DONALDSON. It is in full force, but it is early——

Chairman SHELBY. In full force, but I am speaking, in the time frame of recent weeks, it is just beginning.

Chairman DONALDSON. Yes.

Chairman SHELBY. In that sense.

Chairman DONALDSON. It is. Let me say it is in full force, Senator.

Chairman SHELBY. But you are a long way from completing your investigation.

Chairman DONALDSON. Absolutely. Absolutely.

Chairman SHELBY. Do you intend to look at every mutual fund? I know you are looking at the big ones now, but are you going to let some get swept aside?

Chairman DONALDSON. I think that we sent out Wells notices to a number of funds where we found egregious evidence. We will attempt, one way or another, to get to all of these funds. We are going to put some of the burden, in the early stages here, for having them come forward themselves by talking, as we have, to mutual fund directors, trustees, and the directors of management companies.

We have talked to all of the trade organizations and written letters to the heads, asking them to stimulate the self-policing that should go on. So, we are going to get to all of them.

Chairman SHELBY. You do not believe these people can police themselves, do you? You are not saying that here, are you? I hope you are not.

Chairman DONALDSON. Well, I think we——

Chairman SHELBY. In view of all of what they have been doing, abusing their mutual fund holders, trading for themselves and for special——

Chairman DONALDSON. We are going to——

Chairman SHELBY. Are you suggesting—I hope you are not—that they are going to police themselves?

Chairman DONALDSON. No, no, no. I am not suggesting that. What I am suggesting is that, by the force of what we are doing as we go about this methodically and with great intensity, we will stimulate the fund leadership and directors to insist on their own investigations, to insist on coming to us with their violations. We are going to get to them one way or another.

Chairman SHELBY. But where is the SEC going to be? If you are just waiting on them to come to you, you know, where is the SEC going to be, and what role are you going to play? Are you just going to wait for them to come to you or are you going to go, knowing that the practice is so widespread. I hope you are going to go after the culprits.

Chairman DONALDSON. Please be assured that we are going to.

Chairman SHELBY. Okay.

Chairman DONALDSON. I did not want to misrepresent to you that—you know, we do have 450, close to 500 staff here, but we also——

Chairman SHELBY. Absolutely.

Chairman DONALDSON. —have 8,000 and 6,000 or 7,000——

Chairman SHELBY. Mr. Chairman, we are going to furnish you what resources you need, and I think it is going to depend on what you want to do with those resources.

Mr. Chairman, we have two back-to-back votes, cloture votes on the floor. You can tell by the absence of Members.

Chairman DONALDSON. I noticed that everybody disappeared.

Chairman SHELBY. What we are going to do, we are going to be in recess until we get back. It will probably be at least 20 minutes or more.

Chairman DONALDSON. Fine. Thank you.

[Recess.]

Chairman SHELBY. The hearing will come back to order.

Chairman Donaldson, when this Committee considered the global settlement on research and analysts in May, we heard how the State and the Federal regulators coordinated their investigations and settlement efforts.

Given the size of the mutual fund industry, which you just described earlier, the scope of trading abuses, and the shared goals of State and Federal regulators, it would seem to me that the regulators, that is, the SEC and the State regulators, should once again coordinate efforts. I do not think, to date, a lot of that appears to be happening, and perhaps you have a better view on it.

Are there, Mr. Chairman, ongoing discussions concerning how State and Federal regulators, led by you, can coordinate investigations to more efficiently use resources and to implement broad-reaching reforms, like you have done before? And if not, why not?

Chairman DONALDSON. Well, as I may have mentioned the last time I appeared here, we have brought together a joint committee of State regulators out of NASAA—their trade association—and ourselves. We have met now formally early in November and have an ongoing program of discussing with the State regulators how we can cooperate with them in terms of the jurisdiction, overlap, et cetera, and we are working toward that goal with them.

In terms of the bigger picture and rulemaking, I think, we can do a lot of talking about what the rules should be, seek their advice on that, but the final authority, in my view, must rest with the Federal authority.

Chairman SHELBY. The SEC.

Chairman DONALDSON. The SEC.

Chairman SHELBY. That does not mean the investigations should rest there, right?

Chairman DONALDSON. It does not.

Chairman SHELBY. You are not saying that, are you?

Chairman DONALDSON. As I have said before, and I will say again, we welcome the local authorities. They operate in an area that is an important supplement to what we are doing and, as has been shown, it may not just be a supplement, it may be an initiating factor, and that is all for the good.

Chairman SHELBY. Mr. Chairman, some have suggested that the recent fund abuses, and mutual fund abuses, demonstrate the pervasive conflict between interests of fund managers and fund shareholders. Some contend that these conflicts are a direct result of the 1940 Investment Management Act, which essentially created an industry structure in which each mutual fund more or less cedes control to the investment adviser. If the conflicts, Mr. Chairman, between the shareholders and fund managers are indeed institutionalized, then how do you propose to address these conflicts?

Chairman DONALDSON. I think there are several things that we are doing or plan to do, the most important of which are the setting up of Codes of Ethics at the manager level and at the fund level, the setting up of people responsible for monitoring the ethical guidelines in the management company, responsible for reporting to the fund directors instances where rules have been broken or about to be broken.

I think that the independence of the fund directors is perhaps the most important——

Chairman SHELBY. An independent board?

Chairman DONALDSON. An independent board, independent chairman of that board, and a recognition——

Chairman SHELBY. We do not have that today, do we?

Chairman DONALDSON. No, we do not. Some do, some do not, but it is not——

Chairman SHELBY. It is not industrywide.

Chairman DONALDSON. It is not industrywide. Again, in terms of our settlement with Putnam, although this will be a 75 percent

independent board, no decisions can be taken in certain areas without the approval of just the 75 independent and not the inside.

Chairman SHELBY. Senator Sarbanes.

Senator SARBANES. Thank you very much, Chairman Shelby.

Chairman Donaldson, it seems clear that mutual funds, at least in a number of instances, are paying commissions quite large in comparison to other large investment managers, like pension funds and that these inflated commission costs cost individual investors, if you add it all up, it is small amounts for each investor, but there is a lot of money involved, so you are really talking about billions of dollars. Has the SEC studied the use of commissions by mutual funds to finance the marketing and distribution of fund shares?

Chairman DONALDSON. It is very definitely an area of inquiry for us and an area of concern, in terms of not only the disclosure of that fact to mutual fund purchasers but also how Commission inducements, undisclosed, may be causing brokers to sell certain funds rather than others.

Senator SARBANES. Well, now, Chairman Pitt announced publicly that the Commission would review current distribution practices, including indirect methods of financing and distribution. These were remarks he made to the Investment Company Institute in May 2002. I am now asking whether a study was done, pursuant to that announcement.

Chairman DONALDSON. I am not familiar with that study. Paul Roye tells me that our examination program has been looking at these practices. I want to tell you that I am concerned about the overall use of Commission dollars. As you know, there has been a safe harbor provision for the use of brokerage dollars for the benefit of shareholders, for the benefit of mutual fund shareholders, and I think that this is an area that has to be looked at very closely in terms of are those dollars being used for the benefit of shareholders or are they being used for other purposes, and clearly——

Senator SARBANES. I understand these Commission-generated payments for marketing and distribution, that they are not being itemized or disclosed to fund shareholders by their funds; correct?

Chairman DONALDSON. That is correct.

Senator SARBANES. If that is the case, is that not a violation of Rule 12b–1, which only permits funds to use their assets to pay for distribution, if such payments are made pursuant to a plan approved by fund shareholders and annually reviewed and approved by the fund's board? Would that not be contrary to 12b–1?

Chairman DONALDSON. The issue of 12b–1 is a complicated one, and I would just say, generally speaking, that clearly the use of commission dollars to induce sales of mutual fund shares is not using those commission dollars for the benefit of the mutual fund shareholders. It is using those commission dollars for the benefit of the management company.

Now on 12b–1, that is a cloudy area, and I would like not to comment on that, but I will have to come back to you on the specifics of 12b–1 and the potential violations there.

Chairman SHELBY. I understand there is a Greenwich study of 2002 that the mutual fund complexes with an average size of $32 billion paid an average of $92 million in commissions. This equates to an average of 29 basis points of fund assets that were paid in

commissions. As I understand it, when large pension funds or hedge funds buy or sell shares, they often pay 1 or 2 cents on the stock trades, but the prevailing rate for mutual funds is 5 cents per share. When you add all of that up, this is big money that is at the expense of the investor.

Chairman DONALDSON. Yes. Again, there is a safe harbor aspect of commissions, which allows commissions to be paid for services that benefit the fund shareholders—research services and other services that benefit——

Senator SARBANES. Yes, but don't they have to have a plan in order to do that, approved by fund shareholders, and does the board not have to review and approve it each year?

Chairman DONALDSON. Senator Sarbanes, the board should be approving those expenditures.

Senator SARBANES. Have they been doing that?

Chairman DONALDSON. That is what we are looking into right now. I cannot give you a report fund-by-fund, but that certainly is on our agenda.

Senator SARBANES. How do you respond to the allegations that the SEC, including the Divisions of Investment Management Enforcement and the Office of Compliance Inspections and Examinations, have not been sufficiently aggressive in overseeing and in policing the mutual fund industry?

Chairman DONALDSON. Well, let me put it this way. Those offices have not been sitting on their hands. They have had a series of things that are out, in terms of compliance and examinations, and so forth, that they are examining for, a sense of priorities and so forth. And I believe that, given the risk analysis work that we are doing, that we can improve—vastly improve—the place where risk lies, and I think we can vastly improve the quality and effectiveness of our inspections, and that goes without saying.

You know, we get back to this business of the numbers of funds that we have to look at, and a number of advisers we have to look at, do you have enough people to do it, and clearly the answer to that is we have to be more effective in the way we do it. We have to be more effective in identifying where the real risk areas are.

Senator SARBANES. Oh, I think we have identified a risk area here with respect to the mutual funds.

[Laughter.]

I think that has been, regrettably, pretty well established over the last 3 months. I am concerned about the questions that are being raised about the effectiveness of the Commission of overseeing the mutual funds, whether there is sufficient coordination amongst the divisions. Some have questioned whether the Office of Compliance Inspection and Examinations has sufficient staff and whether the staff is experienced enough to function effectively. I think we have identified a problem area, much to the chagrin of virtually everybody, and we need to get on it.

Now, we are trying to get your budget. There is $841.5 million in the House bill and in the Senate bill brought out of the Committee. We have not passed that particular appropriations bill, but we are very hopeful we will be able to carry that money through for you. You turned some money back in last year, as I understand it, or did you keep it and put it to other use?

But in any event, it seems to me there is a real urgency here for the Commission to get a real action program moving, and that is what I am trying to impress you to do.

Chairman DONALDSON. Yes. Several questions you are putting forth there. Number one is——

Senator SARBANES. I am doing that because my time has run out. I am trying to be fair to my colleagues here.

Chairman DONALDSON. Let me just say that in the inspections area, we have increased our personnel by 40 percent.

Senator CORZINE. Could the Chairman answer what that was from to—you know, the 40 percent as against what?

Chairman DONALDSON. I am sorry, I did not get that, Senator.

Senator CORZINE. What does the 40 percent mean in absolute numbers?

Chairman DONALDSON. In absolute terms, that means we have gone, in just the area of mutual funds and investment advisers, from 350 people to 500 people.

Senator SARBANES. Thank you, Mr. Chairman.

Chairman SHELBY. Senator Corzine.

Senator SARBANES. Wait a minute. I think the Chairman is going to add something else.

Chairman SHELBY. Oh, are you going to answer?

Senator CORZINE. The Ranking Member asked good and detailed questions. There are probably a couple of dangling participles here with regard to his questions. I do not want to interrupt.

Senator SARBANES. Did you want to add anything further? Otherwise, I will turn you over to Senator Corzine.

[Laughter.]

Chairman DONALDSON. I do not know which——

[Laughter.]

Chairman SHELBY. Mr. Chairman, you do not have to make that choice. Senator Corzine is recognized.

Chairman DONALDSON. Let me just say that, clearly, we can improve the effectiveness of the way we go about things, and that is what we are trying to do. That is what I was talking about in terms of risk analysis. That is what we are talking about every day in the agency—how can we do it better.

The only thing I was trying to say was that we have a whole series of things that we do inspect for that are very important. We did not inspect for late trading and market timing, nor has the Commission inspected for that for many years. This is not a new thing. This has been going on for a long time.

Chairman SHELBY. Was that widely understood to be going on in the industry for a long time?

Chairman DONALDSON. I am sorry?

Chairman SHELBY. The late trading, was that widely understood to be going on in the industry? Because it is so widespread.

Senator SARBANES. And the market timing.

Chairman DONALDSON. I can only quote from the press of a former outstanding Chairman of the Securities and Exchange Commission, who publicly stated that it was a surprise to him.

Senator SARBANES. So it is not like Claude Raines in "Casablanca," shocked that gambling was taking place in the back room? It is not like that?

[Laughter.]

Chairman DONALDSON. I do not think so. I think that the extent of this has come as a surprise to even the professionals.

Chairman SHELBY. Senator Corzine.

Senator CORZINE. Thank you, Mr. Chairman.

Building on the questions of the Ranking Member, how often are mutual funds inspected? These 350 going to 500 people, how often do they sit down and examine?

Chairman DONALDSON. Are you talking about what it has been or what it is going to be?

Senator CORZINE. What has been.

Chairman DONALDSON. I think that we have been trying to go on a basis of once every 5 years, if I am not mistaken. Yes, 5 years. And we are trying to cut that at least in half.

Senator CORZINE. I think one could, just on the common sense of that, know that there is some personnel turnover over a number of years inside those mutual funds, that it is a long time to go without having any checks and balances or peeks into the kind of behavior that has maybe happened.

Chairman DONALDSON. Yes. It also goes to trying to get smarter about what you are looking for, through risk analysis, trying to get at things that are going on or may be going on, trying to anticipate that, as opposed to just doing a routine exam.

Senator CORZINE. I think risk analysis is a great idea inside any organization. To some extent, I am not certain I can see how you are going to be ahead of the most creative of those who want to break the rules. There is some possibility that you will think of every possible fraudulent kind of scheme that people can put forward, certainly know as one tried to manage an organization you try to do that so that you could stop things happening before they did. But I think it is a great concept and I welcome it, but I think that actually going in and checking and actually having compliance reviews and supervision reviews, which I think has been an issue with regard to frequency that is really a function of resources and the number of people that you have to be able to do that against 8,000 funds or whatever the number was that you talked about.

I think one of the things we have to do is make sure that we have enough resources matched against the issue that you are trying to supervise and have responsibility for. Otherwise, I think you create a moral hazard, that people think something is going on when it really is not, and that is one of my worries.

One of the concepts that Senator Dodd and I have talked about, which we are not yet recommending, although I am not certain about it, I think a lot of people think the PCAOB is off to a good start, that it is focused entirely on that aspect of our financial system, and will develop an expertise and targeted element, and it is also a way to self fund in the inspection process. I wonder if you thought about that at all at the SEC with regard to future directions, how you provide the oversight and secure it?

Chairman DONALDSON. The PCAOB has an indirect effect right now in terms of the inspections of accounting, auditing standards, et cetera, which will flow into the accounting that is used——

Senator CORZINE. I meant a mutual fund oversight board.

Chairman DONALDSON. If you are referring to a mutual fund oversight board——

Senator DODD. Chairman Donaldson, just to pick up on this, Bill McDonough yesterday made a public recommendation specifically along these lines, to utilize the example in the Sarbanes-Oxley proposal included in the mutual funds. The Dow Jones yesterday reported in an interview with him. Just curious whether you may not have known that.

Chairman DONALDSON. Two answers. Let me just go back for a second to your statement that you are not going to be on top of everybody that is trying to do bad things. Those were not your exact words. But I think that we can be a lot smarter than we are in terms of being out in the field, understanding exactly what is going on. There are a lot of things going on, as there are in any business, and if you are out there and trying to understand—I am not saying cavorting with the bad guys—but talking to people and so forth, I think you can bring a new sophistication to your inspection work that perhaps we have not had in the past.

In terms of an oversight board, as far as I am concerned, everything is on the table in terms of how we address some of the problems. I would be unwilling to say right now that we cannot move ahead with the rules and regulations and remedies that I outlined earlier this morning, and do a very good job doing that. I think we have to prove to you and prove to the country that that cannot be done before we go to the expense and the bureaucracy and so forth of a whole new regulatory entity.

But that is just a personal opinion of mine right now, and, as I say, we are willing to explore and discuss any remedy.

Senator CORZINE. Thank you.

Chairman SHELBY. Senator Dodd.

Senator DODD. Thank you, Mr. Chairman.

Chairman Donaldson, I think that your statement is very good. I appreciated its thoroughness this morning as well—it covers a lot of ground. I think the risk assessment idea is very sound and makes a lot of sense. I agree with Senator Corzine in that regard.

One of my questions was about the Bill McDonough suggestion in his interview yesterday about having a similar type of oversight board here, and ask you to take a closer look at that to see what you think. I did not expect you to necessarily endorse the idea this morning, but we are told it is working pretty well in its present construction in dealing with the accounting industry, and the reactions have been fairly positive, even from the industry, about it.

Chairman DONALDSON. I think that is true.

Senator DODD. It will be worthwhile to take a look.

I just want to, quickly if I can, I want to get to a third question. But let me ask the second question. I reread your testimony here during other questioning going on to see if I understood it pretty correctly. I wonder if you might give us some greater clarity on the independence of the board, and just very specifically independence of the mutual fund boards. Should these boards be entirely independent, two-thirds, three-quarters? Have you given that any more specific thought? How independent should the chairman of that board be, totally independent? Can you be more specific?

Chairman DONALDSON. My own personal view?

Senator DODD. Yes.

Chairman DONALDSON. I think the board chairman should be totally independent, and the further you can go to a totally independent board the better. I think that has to be balanced with some expertise, particular expertise that can be brought to the board. So if we have a 10-person board, if there are a couple people on that board that are ex-employees in the mutual fund industry or that particular mutual fund complex, and bring knowledge of that complex and so forth, I think that if you have 8 people that are independent and 2 inside, that maybe the benefits of the two are there. I would not say 100 percent, but that would be, I would be shooting toward, rather, three-quarters, closer to three-quarters, 80 percent rather than 50 percent.

Senator DODD. What about certification of the accuracy and the integrity of a fund's financial statements?

Chairman DONALDSON. We have taken steps for those funds' statements to be certified in accordance with Sarbanes-Oxley by the chief financial officer and the chief executive officer.

Senator DODD. I wonder if you might look, if you get a chance— we have not put this proposal in legislative form yet, but I think we will sometime possibly this week, and obviously, we will want to see legislative language in something that Senator Corzine and I have put together, but I think we would appreciate getting a response from you about what you think of these ideas. We have covered a lot of ground. Some we have not. As we just mentioned, we have been thinking about it. I would be very interested in what your thoughts might be. Again, you are getting a lot on your plate here, but nonetheless, we would be interested.

Let me jump to the question of the State and Feds. We are going to have other witnesses here on Thursday. We have to break through this in a way. I do not think it is helping the cause to have people back and forth yelling at each other here when we have a lot of work to do. It is not to suggest that people who are making complaints are not without justification.

How do you deal with this thing? We have to break through this. We cannot have you and Mr. Spitzer and the guy in Massachusetts screaming at each other in a public forum every day. That does not help in my view. So what are we going to do about that? How are you going to solve that? Let us get right to it. What are you going to do?

Chairman DONALDSON. I think the first step is for us to move as expeditiously as we can to install the remedial efforts that we are bringing to the table now. I think the faster we can get going the better. I want to assure you that as we move along that path, if we see things that we cannot do—and that gets pretty technical here—but in terms of certain definitions of independence and so forth, you know, that certainly would be helpful if we need legislation for that.

If you are addressing the issue of regulators, State and Federal regulators, in some conflict, public conflict, I think that is very counterproductive. I think it is unfortunate, and we certainly are doing everything in our power to reduce that level of contention. As I mentioned, we are bringing the State regulators together. We are meeting with them regularly, and so forth and so on.

Senator DODD. Are there lines of communication? Is there anything, any effort being made? I mean just having competing op-ed pieces and so forth, I am just worried about where this is going to take us, if we are trying to fashion something here that makes sense. Obviously, there are going to be times when you cannot stop the differences appearing, but are there any structures you can put in place on a regular basis so we can at least minimize where at all possible?

Chairman DONALDSON. We are doing everything in our power to work with the State regulators, and that includes all of them. Unfortunately, we cannot control what certain State regulators decide they want to say publicly. I believe that it is very counterproductive, and we want to continue to work with the State regulators, and that includes all of them. We are doing everything in our power to do that. It gets a little bit frustrating to be working with somebody in partnership, and then read in a newspaper the next day that they are attacking your agency. That does not help the dedicated people in our agency who are breaking their necks to address these problems. I do not know what can be done other than to continue to try and work with them, to continue to recognize the role that they play, to be as candid as we can be, and that is why I wrote the op-ed piece today, to try and explain exactly what we did.

I believe that the criticism of the Putnam settlement was totally unjustified and totally went to an issue of some other people's desire to use the current powers of a State regulator to attack and to bring to fore a whole series of remedies that did not pertain to the specific issue at hand. I believe that we are very conscious of our responsibility for developing remedies for the entire industry and, insofar as we bring enforcement actions, to bring to bear in the enforcement actions remedies that have to do with what we are enforcing. In the case of Putnam, what we were enforcing was the lack of supervision of some of their employees, and a lack of reporting of that, the knowledge of that to the fund directors. And to try and bring in ideas of fees and other things, to that settlement did not seem appropriate.

Senator DODD. But you made the point earlier that the Putnam case is still very much open.

Chairman DONALDSON. Oh, absolutely.

Senator DODD. And the SEC is aggressively pursuing these other questions?

Chairman DONALDSON. Absolutely, and that is part of my concern here with statements made that we have lost the opportunity to pursue Putnam. It is just plain wrong. We have not. In fact, in the other criticism coming out there is the language we use to "neither admit nor deny" and so forth; well, that is language that is used in civil litigation across the Federal Government. It is language that has been used in New York State litigation. It is language that has been used in Massachusetts, so it is counterproductive.

Chairman SHELBY. What about Connecticut?

[Laughter.]

Chairman DONALDSON. I will check that.

Senator DODD. No, stay where you are. You are doing fine.

[Laughter.]

You understand that because this is the kind of stuff that it is critically important we get to the bottom of this, and do what we can to get this back on track again. Senator Corzine has said it better than I have. I think it sends so many different signals at a time when you are trying to do what you can to restore confidence in consumers, investors, in these very important instruments, and obviously we are going to have Mr. Spitzer here on Thursday to hear that side of the equation. But I would just hope that a real effort could be made here to achieve as much cooperation as possible.

I would add just briefly, if in fact the numbers in the staffing requirements are needed here, whatever the SEC needs to get on track with this, I do not know what the schedule is, Mr. Chairman. We have an omnibus appropriation bill coming along. We should find out soon. I would hate to go through another whole year cycle in all of this. So to the extent you can look at those numbers and give us some idea, at least I would be interested to know what the needs may be of the agency so that you can have the people on the ground to do the job.

Thank you.

Chairman DONALDSON. We will do that.

Chairman SHELBY. Chairman Donaldson, I believe you used the phrase earlier that the fund executives had lost sight of their duty. I believe that was your phrase. How long ago did they lose sight of their duty? Did they ever exercise that fiduciary duty, and if so, when did they quit, or do you know?

Chairman DONALDSON. I do not know, is the bottom line. I do not know, and I cannot make a judgment on when some of these practices began. I might say that the blanket indictment inherent in your statement goes a little far. I mean I think there are lots of fund executives out there who——

Chairman SHELBY. The ones who have not been neglecting their duty or have not lost sight of their duty, they will prosper I am sure. This will come out. But the ones that have lost sight of their duty or never recognized their duty, they need to be exposed, for what it is worth.

Chairman DONALDSON. Absolutely.

Chairman SHELBY. If I could borrow Senator Sarbanes' paper, your op-ed piece today in *The Wall Street Journal,* says "Investors first." I do not think the investors have been first in a lot of what we have found out about the mutual fund industry. They should be first just like your op-ed piece headline today in *The Wall Street Journal.*

Along those lines, how much time and effort has been expended by the SEC in supervising the mutual fund industry this year? I know this is your first year there, but since you went on your watch and were confirmed, it is not a long time in your tenure, but I wonder how much time and effort by the SEC was spent looking at the mutual fund industry. Maybe perhaps, well, even with your predecessors too. Let us go back say 10 years, just use 10 years, and if you do not know, could you furnish that for the record because we would be interested in this because if the mutual fund groups were policing themselves, gosh, I do not think they had a gun or a uniform on. It obviously has not worked for the most part.

But we would be interested in what the SEC has done, not only on your watch, but also on Mr. Pitts' watch, on Mr. Levitz's watch and others. I think that would be interesting.

Chairman DONALDSON. We would be very glad to try and put some numbers——

Chairman SHELBY. We are not here to indict you. We are here to learn.

Chairman DONALDSON. Sure. A totally legitimate request, and we will try to do that for you. I think that it is only partially——

Chairman SHELBY. In other words, have you been on top of things at the SEC, or did you think that the mutual funds, no complaints, no problems, everything is rosy. Seven trillion dollars, all this money out there, 95 million Americans, everything was fine. Is that the attitude, or has that been the attitude before the revelations of all the——

Chairman DONALDSON. I can only comment on my tenure, and clearly, we have had an acceleration of attention to the mutual fund industry. We have also, in our Investment Management Division, had an acceleration in our attention to the hedge fund industry.

Chairman SHELBY. Sure, and other scandals.

Chairman DONALDSON. I guess I would say that it is not just a matter of time; it is a matter of the sophistication of the way you go about it. And there is where I think we can do a better and better job.

Chairman SHELBY. Sophistication the way you enforce this and supervise it?

Chairman DONALDSON. Oh, no, no, no.

Chairman SHELBY. What do you mean?

Chairman DONALDSON. I am not worried at all about our——

Chairman SHELBY. Sometimes you have to use a sledge hammer, if it calls for it.

Chairman DONALDSON. What I am saying here is that I think that our anticipatory power—I will make a statement now that probably I have no right to make, but I will anyway, and that is that had we had hedge funds under our purview, perhaps, just perhaps, we might have had a screening device to look at how hedge funds were doing and how they were doing it, and we might have discovered that certain hedge funds were getting a large portion of their profits from market timing kinds of transactions, which might have led us into looking at that issue.

We did not, and the fact of the matter was that in the case of Canary that was a collusive arrangement that was purposely hidden and only came to the fore via a tipster, if you will, going in and explaining it. But it is not something—but I think the chances of having picked that up would have been enhanced had we had more jurisdiction over hedge funds.

Chairman SHELBY. Mr. Chairman, I can tell you, we have had hearings on that here. I think this Committee and this Senate will give you as SEC Chairman, the tools, the legislation, the authority to do whatever you need to do to police the securities industry, to do it right, and that of course includes mutual funds, and what we need is some guidance from you, some help, and we will certainly continue to work with you and our staffs.

In your testimony, Mr. Chairman, you described a comprehensive rulemaking initiative that calls for a number of rulemakings in December and January for additional study of certain issues. When do you expect the SEC to complete its rulemaking addressing the range of problems in the mutual fund industry?

Chairman DONALDSON. As I say, our first round of—I should say second and third round because we have done a number of things in the mutual fund industry up until now, in terms of mutual fund advertising and so forth—first round in connection with late trading and market timing comes in early December, December 3. We think right after the turn of the year we will be prepared on some other things.

One of the challenges in rulemaking is to anticipate the unintended consequences of some of the rules that you make, and so it is a deliberate process. And if it is rushed too fast, without properly putting the rule out there for comment, then you make rules that have unintended consequences.

Chairman SHELBY. Chairman, do you at the moment, or did you say 3 months ago, have the authority to police the mutual fund industry had you focused on it, had the SEC investigators been involved in all aspects of it? Did you have the authority and did you have the manpower? Did you have all the tools to do the job?

Chairman DONALDSON. Did we have those tools a couple months ago?

Chairman SHELBY. Did you then and do you now? And if not, we want to help you get those tools.

Chairman DONALDSON. I think we were building rapidly. We have made substantial progress in adding to our staff. We have to train that staff. So in effect, although we have more people there in our inspection group, we have to train them to be good inspectors. That takes time. So, I think any of the inadequacies that are there because of inadequate personnel are gradually being resolved. I think it is clear that we had other priorities that we were inspecting for, and, in terms of what has developed now, we should have had a higher priority on market timing and late trading.

Chairman SHELBY. How important is the problem that you are facing with the mutual fund industry?

Chairman DONALDSON. How important is the——

Chairman SHELBY. How important is the problem that is facing you with the SEC.

Chairman DONALDSON. Oh, I am sorry.

Chairman SHELBY. You are head of the SEC. How important is that problem? Has it gotten to be one of the number one priorities?

Chairman DONALDSON. Hugely important. Very important. You cannot have something affecting this number of people, this number of investors with their savings without having it right up at the top of our priorities.

Chairman SHELBY. How do you get the word out to the mutual fund people that you are not going to tolerate, the SEC is not going to tolerate, the Congress is not going to tolerate cheating and stealing and all these things that go on in the industry, taking advantage of the mutual fund shareholder?

Chairman DONALDSON. I think the word is out there. I think it is out there in a number of different ways. I have tried to speak

about it, as have the other professionals in the agency who speak about these things. I believe that we have made it very clear in terms of our examinations, our concern. I think we have made it very clear in terms of our conversations with the trade organizations. I think the word is out there, and we will continue to push it out there. It is a number one priority for us to remediate these problems, and we are going to do it.

Chairman SHELBY. Thank you.

Senator Sarbanes.

Senator SARBANES. Thank you, Chairman Shelby. I know the hour grows late and we want to move ahead and we want to get at Mr. Fink and Mr. Lackritz. Actually, that is not a felicitous way to express it.

[Laughter.]

I am sure that we want to hear their testimony and have a chance to——

Chairman SHELBY. We look forward to their appearance.

Senator SARBANES. Yes. But before the Chairman leaves, I just want to send maybe a somewhat different signal.

It is my perception that the State officials, securities commissioners and attorneys general, play a very important role in complementing and supplementing the work of the SEC. There is some back and forth now, and I understand those sensitivities, but all of you, they and the SEC, operate within a framework whose end objective is to serve the public interest. And in the past I think we have benefited from that. The SEC does not begin to have the kind of resources and staff it would need to do all of the monitoring and policing that is done at the State level by these various attorneys general and securities commissioners. Would you agree with that observation?

Chairman DONALDSON. Absolutely.

Senator SARBANES. There are some efforts in Congress, not here, fortunately, but in some places, to pass statutory provisions which seek to restrict or limit or knock these State officials, if not entirely out of the picture, partly out of the picture. I take it the SEC is not behind that or supportive of that in any way. Would that be a right perception?

Chairman DONALDSON. The SEC has said in every way possible that it welcomes collaboration with the State officials. Having said that, the SEC says continually, and I have said continually, that when it comes to writing the rules, that that has to be our responsibility, and insofar as State regulators step over the bound in settlements and attempt to write rules that should be Federal rules——

Senator SARBANES. The rules that were written—I mean the only thing that I understand that potentially fits in this category were the rules on Wall Street where the analysts and the SEC participated in the writing of those rules, did it not?

Chairman DONALDSON. That was before my time, most of it was, and the answer is yes. But as you know, the combination of regulators attempting to get together and write these rules does not necessarily end up with exact rules that, if there was one regulator there, that you would write. We know the issue of compromise and adjustment and so forth inherent in that.

Senator SARBANES. I think one thing that has come through rather clearly through all of this is that if a vacuum exists, if a problem has developed, if investors are being abused, if the public perceives that the public interest is not being addressed, then whoever moves into that vacuum is going to be welcome. And all this does in effect is underscore some of the line of questioning I and others were pursuing earlier of how imperative it is that the SEC really be geared up in order to deal with these matters. Now, we know you are trying to do that, and I think the risk analysis on a broad basis is one thing. We have this risk and we need to address it, but I think it underscores the need for the SEC to move ahead in a very vigorous fashion, and as the Chairman says, we are supportive of that. We are prepared to support additional authorities if you judge that they are necessary, although some think you have quite extensive authorities as it is, and of course a budget, which we are trying very hard to get for you. I mean the budget of the SEC will virtually double over a 3-year period, and we need to put those resources to work. We have tried to send a signal to your employees that we are supportive of them. We want to boost the morale. We think you have had that impact on the agency in that regard, and we want to push that forward.

I understand a certain amount of this back and forth that is going on. I know people are sensitive. No one is more sensitive to criticism than Members of the Congress of the United States, that is for sure. However, I do not think we should get so sensitive that it in any way might impede the substantive work that is ahead, because there is plenty of substantive work, in my view, for the Commission and for the State Attorneys General and the State Securities Commissioners, wherever the particular State may place the responsibilities.

Thank you, Mr. Chairman.

Chairman SHELBY. Senator Corzine.

Senator CORZINE. Thank you, Mr. Chairman.

Let me congratulate Chairman Donaldson for what I think is actually one of the most important issues, that while we focus on mutual funds, the idea that almost every tough situation we come in, the vacuum of lack of oversight of hedge funds. I do not think all hedge funds are bad. There are all kinds of good players and bad players in almost any industry. But the repetition of this without any kind of supervision I think is something that we all need to pull together on and try to put together an oversight that does not leave such an important part of our financial system completely outside of those purviews. I do not understand how the risk analysis system would actually work when some of these ideas generate outside of the purview of supervision. I congratulate you for focusing on that. I think it is a major step forward, to hear the Chairman of the Securities and Exchange Commission say that we should be addressing this. I just want to be on record of supporting that and looking forward to working with you on how that can be done in a way that does not undermine liquidity and depth of markets, but gives people a little more confidence that every time there is a problem in the industry, it does not somehow have some juxtaposition to what we have seen on a pretty regular basis. If you go back in history, I think that can be identified pretty clearly.

One area that we have only touched on, but I think is extraordinarily important in this whole issue, and as you have identified in the Putnam discussion, you deal with one issue and you carry that through, at least from your perspective. It seems to me that there is virtually no ability for someone, just a normal human being, to sit down and do comparative shopping in this industry. It is very hard to figure out what the total costs are to an individual for managing the funds. I think about management issues, distribution issues or costs, management costs, distribution costs, and service provision to the groups. It seems to me that that is virtually impossible for any shareholder to know what it is that they are actually paying to get the investment services that they are having.

I will take a little bit of both pride and probably shame in the proposition that somehow we need to get to a composite cost of what it is the investor is paying to get to the return that they are asking for. Are you all working on concepts that will do that, more than just giving a laundry list of what might be charged?

Chairman DONALDSON. Absolutely. First of all, I totally agree with you in terms of the difficulty for a ordinary investor. I might add, the difficulty——

Senator CORZINE. I do not know if you have to be too ordinary.

Chairman DONALDSON. Yes. It is difficult even for people who are very sophisticated in finance to define exactly what is going on, exactly what those costs are.

Yes, we are working on that. We are working on a revised way for the funds to put that forth to a perspective buyer, either in the confirmation or better yet before the purchase is made, so that the buyer knows exactly what they are buying. That is very, very much front and center with us.

Senator CORZINE. I am sure Senator Dodd would say the same. I really believe, and I am sure the Chairman and Ranking Member feel the same way, this is an area that needs real depth to come to the right answer, where people can actually do a comparative shopping about how people are pricing the service that supposedly it is giving, which is incredibly difficult to derive in this process.

I take that one step further on 12b–1 fees, were those originally formulated to start a fund, or were they ever anticipated, do you know from study and discussion inside the Commission whether they were ever intended to be a permanent feature?

Chairman DONALDSON. I do not know the history of it, Senator, but I do know that those fees have not always been there, and I think there are probably people in the room who can give the history of just exactly when the 12b–1 fees came in. I think it had to do with giving an assist to the funds and raising money which would rebound to the benefit of all shareholders by having a broader base of capital, and therefore the expenses would be less because you had a broader base of——

Senator CORZINE. Logic would say at some point that you have captured some of those economies of scale, logic presumed.

Chairman DONALDSON. Logic presumed, that is an area to take a look at, sure.

Senator CORZINE. Thank you, Mr. Chairman.

Chairman SHELBY. Chairman Donaldson, we appreciate your patience here with us today. We appreciate your statement, and I am sure you will be back. We will continue working on this. This is not an issue that is going to be swept away, and it is certainly not going to be swept under the rug.

Chairman DONALDSON. Thank you. Delighted to be here.

Chairman SHELBY. We are now going to call up our second panel. Matthew P. Fink, President of the Investment Company Institute, and Marc E. Lackritz, President of Securities Industry Association.

Your written statements will be made part of the record. You have sat through these hearings already today. If you could sum up your opening statement within 5 minutes, it would help us move along.

Mr. Fink, we will start with you.

STATEMENT OF MATTHEW P. FINK
PRESIDENT, INVESTMENT COMPANY INSTITUTE

Mr. FINK. Thank you, Mr. Chairman.

I have to say that I am appalled by the circumstances that made you call this hearing. Like you and the other Members of the Committee, and most importantly, your constituents, I am personally outraged by the betrayal of trust and fiduciary duties exhibited by people in the fund industry.

I have represented the fund industry at the Institute for 32 years. I started when the industry had total assets of $54 billion, which is less than 1 percent of what they have today. I have often been asked over the years, including by Members of this Committee, why has the fund industry succeeded so well? There are a lot of reasons, but I have always said the core reason is the 1940 Act, its tradition of integrity, and I regret to say with all my heart that today that tradition of integrity is widely questioned.

The industry's goal today is simple. We want to work with you and other policymakers to rebuild trust, renew investor confidence and reinforce our previous history of putting the interest of investors first.

I think action should be taken in three areas. First, Government officials must identify everyone who violated the law. Those who acted willfully against the interests of fund shareholders should be sanctioned and sanctioned severely. And those who are found to have violated the criminal laws should be sent to prison.

In response to a question, Mr. Chairman, you had of Chairman Donaldson, what is the best way to get the message out to the fund industry? That is the best way.

Second, shareholders who were harmed in any of these funds should be made right. It is a particular outrage that some funds permitted a few large shareholders to prey on smaller shareholders. This repudiates perhaps the most fundamental principle underlying mutual funds, that every shareholder, large and small, should be treated alike.

Third, effective reforms have to be put in place to make sure that this kind of thing never happens again. Last month our Chairman, Paul Haaga, said, “Everything's on the table.” That was not just a cute sound bite. It was a call to action for the industry, and indeed,

a few weeks after that, we called for major reforms in three of the areas that have been revealed by the investigations.

First, with respect to late trading, trades coming in after 4 o'clock but getting the 4 o'clock price, we have urged the SEC to require that all fund transactions must be received by the fund itself by 4 p.m. I was very glad to hear Chairman Donaldson indicate that that is what the SEC will propose.

Chairman SHELBY. How would that work, Mr. Fink?

Mr. FINK. That would mean that presumably if you had an account with a broker, right now you can hit the broker by 4 p.m. This would probably mean you would have to hit the broker by 2:30 p.m. If you are in a 401(k) plan, many of them take a day to process, so it would probably mean if you put your order in today, you probably would not get today's price, you might get tomorrow's price. But for 90 percent or more of fund shareholders who are buying for the long-term, you and I in our 401(k) plan or Government Thrift Plan, we are not trying to buy today's price or tomorrow's price, we are putting our money in for the long-term. I think to stamp out late trading, which is against the law, but we found, according to Mr. Cutler, 10 percent of fund companies saying they are aware of it, 25 percent of brokers surveyed saying they were doing it, you are going to need some tough medicine like that.

I have to say though that if technological developments now or later can occur which give the same assurance that if the order reaches the intermediary, the broker or bank by 4 p.m., that that can be as foolproof as reaching the fund by 4 p.m. We would support that as well. But for the moment, until somebody can show us or the SEC or the Congress something as good as a hard 4 p.m. at the fund, we will back a hard 4 p.m. at the fund.

The second reform is abusive short-term market timing, and there we have urged the SEC to require all long-term mutual funds to impose a 2 percent redemption fee on any sale of fund shares within 5 days of purchase. All fees collected would go to the fund and not to its adviser. I am convinced, as are people in the industry, that an across-the-board uniform 2 percent redemption fee has to be mandated to stop abusive short-term trading. You heard Chairman Donaldson before talk about the problems in omnibus accounts. These are accounts by brokers or banks or 401(k) plans where the fund has no idea who the individual shareholders are and has no way to police their individual activities. Intermediaries say rightly that they cannot police 20 different fund groups' special rules to get at these short-term timers, and that is why a 2 percent across-the-board fee would get at that. Every intermediary could impose it easily.

The third issue that came up in the investigations, Mr. Chairman, is the worst probably, and that is short-term trading of fund shares, not by outsiders, not by hedge funds, but by fund portfolio managers and indeed senior executives. And we stated our support for any steps to make it clear that that kind of practice is not just repellant, but should be made illegal.

These were our initial recommendations which were designed to address the three major abuses that came out of the investigations. I also have to say, the need for additional reform is absolutely clear. Fortunately, we do not have to begin the process from

scratch. We have a strong foundation in the Investment Company Act.

Today, I must say I heard Chairman Donaldson lay out a laundry list. Senator Dodd referred to the legislation he and Senator Corzine are drafting. I would be happy to comment on the specifics of any of that.

I just say, going back in history, this Committee passed unanimously the Investment Company Act in 1940, which set the foundation for the modern mutual fund industry. A number of observers including consumer advocates have pointed to the Investment Company Act as one of Congress' greatest achievements. I will make three points about the Act. First, it is much more demanding than the other securities laws, much more restrictive. Second, it is the only securities law that passed the Congress unanimously, and third, it is the only securities law that was supported by the industry it regulated, the mutual fund industry.

When the Act was signed in 1940, the President made mention of the fact that it was supported by the industry, and asked that the industry continue to cooperate with the SEC and the Congress in the future. The Institute has done that for 63 years, and we pledge to continue to do so.

On a personal note, I might say that just before these scandals broke out, I announced that I would retire from the Investment Company Institute at the end of 2004. I want to personally promise every Member of this Committee that I will use all of my energies during this time to ensure that abuses are effectively addressed and regulatory weaknesses are remedied.

I have to say that revelations about corporate misconduct during the past 2 years and about mutual funds since September 3, provide reason for all of us to be cynical about how American businesses approach their responsibilities. But I hope if my appearance today is remembered for only one thing, it is the following. The Investment Company Institute is truly horrified at the betrayal of shareholders that has occurred at some mutual fund companies. We understand completely that enduring trust and confidence in funds will not be achieved by words or half measures. As the reform process continues, you and other policymakers should expect a lot from us. I respectfully ask only one thing, that our commitment to reform be judged by our actions.

Mutual funds, as other witnesses have said, are where Americans invest. In over half of all households, more than 60 percent of middle-income households, funds are an integral part of people's financial lives and an integral part of our capital markets. If we all do not get together and fix these problems, I think we all will suffer, and we cannot let that happen.

Thank you.

Chairman SHELBY. Thank you.

Mr. Lackritz.

STATEMENT OF MARC E. LACKRITZ
PRESIDENT, SECURITIES INDUSTRY ASSOCIATION

Mr. LACKRITZ. Thank you, Mr. Chairman. I appreciate the opportunity to be here in front of the Committee to talk about these

issues involving the integrity of both mutual funds and the broker-dealers that I represent.

While regulation of the securities industry is really based on the two principles of full disclosure and competition, the core bedrock asset underlying the success of the industry in the markets is the public's trust and confidence in the markets and in the professionalism of the individuals participating. So, we find anything that impugns the public's trust and confidence to be of the most urgent nature, and therefore, we pledge to do everything we can, Mr. Chairman, to work with you and the regulators to earn back the public's trust and confidence in this area.

Over the past 10 years our industry has raised more than $21 trillion of capital for economic growth, for new enterprises, for new processes, for new systems, for hospitals, for roads, and for schools. That is only possible if the public has trust in the integrity of the markets so that the markets can efficiently and effectively channel capital from institutions and individuals that have it to institutions and individuals that need it.

Mutual funds are the vehicle by which an overwhelming majority of investors participate in our markets, and as a result we are very dependent on the health and integrity of the public's continued robust participation in mutual funds and in the capital markets. The most recent numbers indicate that mutual funds owned a little more than one-fifth of the equity market capitalization. So, there are significant participants in the capital markets, and our ability to perform our roles as intermediaries depends on their continued vitality.

Moreover, the retail investor is the backbone of both the mutual fund industry and our markets, and investors, as has been stated earlier by Chairman Donaldson and by Mr. Fink, have to come first. Our core value that we have been pushing in our industry has been to make sure to put clients' interests and customers' interests first if we want them to continue to entrust their money to mutual funds. They also must be assured that fraud, self-dealing, and dishonesty will not be tolerated in any way, shape or form. All investors have to be treated fairly and all aspects of the mutual fund business, including fund fee structures, financial incentives offered to intermediaries to recommend specific funds, fund investment and redemption policies and fund governance, must be as transparent as possible to investors and to the public.

In addition, all investors should be assured of reasonably prompt execution and fair pricing of their mutual funds transactions.

The recent behavior that has been addressed involves three issues that I would like to speak to. One is late trading or market timing in contravention of stated fund policies. Two is lack of full disclosure, and three is operational shortcomings relating to breakpoints. All of these instances share one element, Mr. Chairman—they hurt investors. Each of these issues has to be addressed swiftly and comprehensively by tough enforcement actions first and foremost where wrongdoing has occurred, by thoughtful regulatory revisions to make sure that these problems will never recur again, and by legislation to fill in existing gaps in the law where they may occur.

At the same time it is equally important that regulatory or legislative solutions do not create new problems or other unintended consequences for investors in the course of remedying these existing ones.

First of all, with respect to late trading, we, like everyone else, have been appalled by the number of instances of mutual fund late trading. In addition to stringent, tough, sure enforcement actions, we believe additional regulatory actions should be taken to ensure that these abuses can never happen again. Any new regulation here should make sure to be reliable and bulletproof to any new forms of evasion, should make sure to give investors—all investors—the widest array of opportunities to trade on information in the marketplace, and to treat all investors, large and small, institutional and retail, alike, equally. Finally, it should make sure to synchronize any new mandates with the existing and well proven operational systems that clear and settle these transactions today.

Several proposals have emerged to address late trading by establishing a hard close for open-end mutual fund purchase or redemption that assures that order acceptance could be later than the New York Stock Exchange closing at 4 p.m. As discussed in greater detail in my written testimony, we think that a hard close that can only occur at the mutual fund has some very significant drawbacks for investors, and also may have some major operational difficulties. A hard close at the broker-dealer or other intermediary would be preferable from the vantage point of most retail investors and retirement plan participants. In any event, we must demonstrate to the public not only that late trading will be punished severely, but also that it will be foreclosed from ever happening again.

Now with respect to market timing, recent enforcement actions and press reports of ongoing investigations appear to involve instances in which funds and intermediaries facilitated market timing transactions despite statements in the fund prospectuses that the fund would not assist in such activities. We fully agree with SEC Chairman Donaldson that rules regarding disclosure of fund policies and procedures on market timing should be tightened, and that funds should be required to have procedures to fully comply with any representations that they make concerning their market timing policies.

We would also propose a requirement that sufficient trade level customer detail be provided to funds to assist them in identifying market timing activities on transactions submitted by intermediaries on an aggregated basis by these omnibus accounts. A further step would be to permit funds to impose a fee on any fund shares redeemed within five days of purchasing them. And finally, we support SEC action to address the overall issue of stale pricing, because stale pricing really is at the core of these kinds of abuses. People take advantage of the stale prices. If we could find a way to eliminate the stale prices, that would go a long way to eliminating these abuses in addition to these other regulatory actions.

In the area of disclosure, Mr. Chairman, we favor clear, direct, timely disclosure of all material information to investors in a central place or central document. It is important to make it investor accessible and investor friendly, rather than a “where’s Waldo” search through fragments of disclosure for relevant information. In

that vein, we strongly support efforts to enhance transparency of revenue sharing and differential compensation to mutual fund investors. We also believe investors should have full, complete, and useful information on fund fees, since they can have a significant effect on an investor's return.

The most efficient means for providing this information to investors, and the basis on which they can do comparability surveys and use comparison shopping to see what others are offering, is to calculate these expenses based on a hypothetical $1,000 investment. We also believe that mutual funds should ensure effective disclosure of soft-dollar practices, both to investors and to fund trustees.

Finally, we have worked very closely with regulators to ensure that broker-dealers and funds are adequately addressing breakpoint concerns. We are exploring additional ways in which breakpoint policies can be made easier to apply. In this way the risk of any further operational problems regarding customers receiving the correct breakpoint would be significantly reduced.

Like many investors, regulators and yourselves, we have been surprised and extremely dismayed by the reports of abuses relating to the sale of mutual funds to investors. We are fully committed, Mr. Chairman, to addressing these concerns thoroughly by supporting vigorous enforcement of current rules and by supporting appropriate legislative and regulatory reforms where appropriate.

We and our member firms will work with you, Mr. Chairman, and your colleagues to ensure that mutual fund investors once again can have justifiable faith in these products and our markets. We look forward, Mr. Chairman, to working with you and the Committee to earn back the public's trust and confidence.

Thank you very much.

Chairman SHELBY. Thank you.

Mr. Fink, some have stated that market timing and late trading activities have long been open secrets in the fund industry. Prior to the recent revelations regarding late trading and market timing, were you, sir, aware of such practices, and how did the Investment Company Institute advise its members to address such practices?

Mr. FINK. Late trading—I was totally unaware. Late trading is a direct violation of the law. I could imagine or may have imagined some inadvertent——

Chairman SHELBY. You did not know anything about it?

Mr. FINK. Never dawned on me, no, sir. Market timing, we knew a lot—first of all, there is some innocent market timing where people are reallocating, but the abusive——

Chairman SHELBY. And some noninnocent market timing.

Mr. FINK. Sorry.

Chairman SHELBY. There is some noninnocent market timing.

Mr. FINK. Noninnocent is what I am talking about. We knew a lot was going on because we could look at the redemption rates of international funds, which were high. And we read Professor Zitzewitz's paper. Our members came to us and said, "We need more tools to combat it." So, we worked with the SEC. They came out with a release on addressing fair valuation, to address stale pricing. We did a compliance guide for our members. We went to the SEC to get an increase in redemption fees. So, I knew a lot was going on, but it never dawned on me, Mr. Chairman, that anybody

at a fund group was selling outsiders the privilege to market time for a quid pro quo, no less than anybody in the fund group themselves were doing this abusive timing.

I did find, going back through our files, one member told us—a couple of years ago—told one of my colleagues they were approached by an outside—it was a hedge fund or Canary—and dismissed it, told him to go away. I thought that was a fluke. It is incredible, but nobody at the Institute, SEC, NASD, that I have spoken to, ever had a clue that this stuff was going on.

Chairman SHELBY. Were they blind themselves, or were they blind because they did not want to see anything?

Mr. FINK. Well, I do not know the answer to that.

Chairman SHELBY. Okay. Sir, I will ask you the same question. You represent the broker-dealers and so forth, the people who make the trades. Prior to the recent revelations regarding late trading and market timing, were you aware in the securities industry of such practices? And if so, how did you react to them? Because they were going on with your people.

Mr. LACKRITZ. Mr. Chairman, with respect to late trading, I had no knowledge whatsoever that that was going on. First of all, it is clearly against the law. I mean, it is clearly illegal. And, therefore, anybody engaged in this would have to expect to be prosecuted. I had no knowledge of any of that.

Chairman SHELBY. No rumors, anything? Anything just widespread, this deep, as Senator Sarbanes said, involving the amount of money involved?

Mr. LACKRITZ. I suspect in retrospect you could look back and say if somebody were going to follow the money and try and figure out where the money was going back during a period of time and you saw assets building up in some part of the market that was heavily engaged in certain kinds of trading, perhaps in retrospect you would say, Ah, that is where we should have gone. But I can tell you, I had no knowledge of it whatsoever, and I do not know of anybody else either in our organization, in any of the self-regulatory organizations, in the Commission——

Chairman SHELBY. Had the SEC ever notified you or shown any interest in this kind of stuff, late trading, market timing?

Mr. LACKRITZ. No, sir.

Chairman SHELBY. What about you?

Mr. FINK. Well, market timing, we knew a lot was going on with stale prices, so the SEC sent out letters to me or to the industry telling——

Chairman SHELBY. When was this?

Mr. FINK. Two or 3 years ago? I am losing my dates. In 2001.

Chairman SHELBY. By a letter, what do you mean?

Mr. FINK. There was a letter from an assistant director at the SEC reminding people that on valuation of securities, foreign securities, after the foreign market closed there was a "significant event," the fund better consider not using those closing prices in Tokyo but use fair value.

Chairman SHELBY. And what happened to that letter? It wasn't heeded, was it?

Mr. FINK. No, a lot of people did heed it. But I cannot tell you the level of compliance, Mr. Chairman, because we, my colleague

behind me, prepared a compliance guide for our members to help them comply. And so, I think people did comply. I cannot talk about 100 percent, but there was compliance.

Chairman SHELBY. Senator Sarbanes, you have a question?

Senator SARBANES. Yes. Steven Cutler, the Enforcement Director of the SEC, has said, "More than 25 percent of firms responding to an SEC mutual fund inquiry report that customers have received 4 p.m. prices for orders placed or confirmed after 4 p.m." More than 25 percent. "Fifty percent of responding fund groups appear to have had at least one arrangement allowing for market timing by an investor." Fifty percent.

"Documents provided by almost 30 percent of responding brokerage firms indicate that they may have assisted market timers in some way, such as by breaking up large orders or setting up special accounts to conceal their own or their clients' identities, a practice sometimes called 'cloning,' to avoid detection by mutual funds that sought to prevent abusive market timing. Almost 70 percent of responding brokerage firms reported being aware of timing activities by their customers."

Now, I have just listened to both of you, and it is a problem for all of us. Why weren't we aware of this? Why wasn't something done about it? Why didn't the Congress get at it? Why didn't the SEC get at it?

But you sit at the top of the pyramid of your industries, and you are telling us here today, we did not know this was happening; it came as a total surprise to us. Yet, as the Chairman indicated in his question, we get reports now coming into us that say, well, it was an open secret that this was taking place. You have this survey now by Cutler that has these, 30 percent, 50 percent, 70 percent. I mean, what was going on?

Mr. FINK. This is no defense, Senator, but remember, neither the SIA nor the ICI are SRO's. We are trade association lobby groups, and we do not go out and inspect our members. So, we would hear it almost as people would come to us with a problem. Again, we knew about market timing. And you cannot tell from that response, Senator, when Mr. Cutler said about funds or brokers, you cannot tell was it abusive or not. I have it in front of me.

Chairman SHELBY. Well, you could tell if it was abusive if you looked closely at it, though.

Mr. FINK. No, from what Mr. Cutler even said in testimony, I think, he could not tell in each case was it abusive or not.

Chairman SHELBY. He did not look closely enough.

Mr. LACKRITZ. If I could just talk about it, the market timing per se is not illegal. The problem here is that it was allowed to happen selectively in exchange for a quid pro quo to the detriment of every other fund shareholder.

Chairman SHELBY. So, they betrayed the shareholders, is what they did.

Mr. LACKRITZ. I am sorry?

Chairman SHELBY. They betrayed the shareholders.

Mr. LACKRITZ. Absolutely. Right, that is correct.

Chairman SHELBY. They were dealing on the side.

Mr. LACKRITZ. That is correct.

Senator SARBANES. I take it, though, from your answer, Mr. Fink, about being a trade association that neither you nor the SIA feel any special or particular responsibility for the practices by your members. I mean, you are simply there to lobby against legislation or for legislation that affects their interests or to try to, I guess, strengthen their position within the industry and so forth. But you feel no responsibility with respect to addressing these——

Mr. FINK. No, not at all, Senator. I simply meant that my own awareness of this issue, I do not go out and—we do not inspect and know what is going on day-to-day. I feel full responsibility, more than I can say, for these wrongs, and I and my organization will do everything to correct them. That is why we have called for these three tough measures that a lot of our members do not like, I have to say, Mr. Chairman, a lot of intermediaries do not like. That is why I am supportive of what I could hear Chairman Donaldson say. So if I misspoke, I do feel responsibility. Simply on the narrow issue of why I did not know, I am not out there, my staff is not out there inspecting funds and brokers.

Senator SARBANES. Let me just close, if I could, Mr. Chairman, with this one quote.

Chairman SHELBY. Okay. Go ahead.

Senator SARBANES. On March 12 of this year, the Chairman of the ICI appeared before the House Financial Services Committee and made the following statement: "The strict regulation that implements these objectives has allowed the industry to garner and maintain the confidence of investors and also has kept the industry free of the types of problems that have surfaced in other businesses in the recent past. An examination of several of the regulatory measures that have been adopted or are under consideration to address problems that led to the massive corporate and accounting scandals of the past few years provides a strong endorsement for the system under which mutual funds already operate."

Now that is your Chairman telling the Congress.

Mr. FINK. If I can try to speak on his behalf, Senator, he did not know about these issues either. The legislation proposal that he was talking about had nothing to do with late trading, market timing, selective disclosure. These issues blindsided him as much as they did Mr. Lackritz and me. I think what he was referring to, Senator, was that, for example, in 1940, the Congress mandated a system of independent directors for mutual funds, and that model I think was used in Sarbanes-Oxley, and then the New York Stock Exchange using unlisted companies. That is what I took his remark to mean, but I have to say he was as innocent—if that is the word—or dumb as I was because none of us knew this stuff was going on in March when he made the statement.

Chairman SHELBY. Mr. Lackritz, most individual investors, as you know, do not have the same level of financial sophistication as their broker. So, they trust or have heretofore trusted their broker to place them in a good investment. That is the order of the day. For this reason, and among others, I am very concerned about the allegations that brokers sold investors more expensive Class B fund shares in order to boost their own brokerage commissions. In these situations, brokers knowingly took advantage of their clients who may not have understood the technicalities of loads in 12b–1 fees.

How do you modify internal compliance programs to halt such activities? Further, how do you move beyond rules and regulations to change the corporate ethics so that brokers do not feel like they can take advantage of their clients? I believe myself that the mutual fund industry—and I hate to say this—is deeply tainted right now. You can see the exodus of money going out. Maybe not all funds, but it is widespread. Do you want to respond?

Mr. LACKRITZ. Yes, absolutely, Mr. Chairman, and I think the question you are speaking to is something where we have an obligation to do everything we can both to change the culture, to make sure the values are right, and to drive that through organizations.

Chairman SHELBY. Not take advantage of the unsuspecting, innocent people who trust you to do these things.

Mr. LACKRITZ. A lot of it has to do with making sure that our industry and our professionals understand that the most important value is to put the interests of the customer first, and that we emphasize that over and over again. In addition, we at least as an organization provide a series of professional education programs for our professionals so that they can continue to improve their level of understanding.

I would also suggest that Steve Cutler's notion that each firm should do an internal audit of every single one of its business practices to identify conflicts and to either eliminate them or disclose them, and then to manage them more effectively is what a number of our firms are currently undergoing.

I know a number of our largest firms have already initiated internal audits so that they, in fact, go through every single one of their processes, every single one of their products, to identify where there are potential conflicts. Then they either work to eliminate the conflict or to manage it and disclose it effectively to investors.

But I think it gets back, Mr. Chairman, to something you said earlier. It gets back to a question of values and culture, and I think that is the most important issue, where we have to recommit ourselves to a culture of putting the customers' interests first.

Chairman SHELBY. It is going to be hard, too, isn't it?

Mr. LACKRITZ. Well, yes, but I think this obviously has been a wakeup call for all of us, and I know our industry and my members take this very seriously. They are as appalled as anybody else at this kind of behavior and committed to doing everything we can to turn it around.

Chairman SHELBY. Is there any one thing that is more important than trust?

Mr. LACKRITZ. No, there is nothing more important than trust. Plus it takes a very long time to build up a relationship of trust, and it just takes, you know, one incident to throw it away.

Chairman SHELBY. Absolutely.

Mr. Fink, many contend that the conflicts between fund managers and shareholders are institutionalized in the structure of the fund industry. To address this conflict, some have proposed various reform proposals such as requiring funds to have boards with a super majority of independent directors and an independent chairman, and to submit the advisory contract to competitive bidding process. What are your views on this and other governance reform proposals?

Mr. FINK. I think there is an inherent conflict, but it is true in every area of money management—pension management, bank trust departments. It is what Justice Brandeis called "other people's money." The Investment Company Act attempts to put checks and balances in, and I think they can be improved. The Act requires 40 percent of the directors to be independent. The SEC by rule has made it a majority. The Investment Company Institute's best practices make it two-thirds. I think Senators Dodd and Corzine's legislation talks about 75 percent. I think increasing it would be a good thing, to two-thirds to 75 percent.

The second thing that would be good would be a tougher definition of "independence." Under the current statute, you can work as a fund manager, leave, and in 2 years come back as an independent director. I think that is a mistake. Our best practices say if you ever work for the manager, you cannot come back as an independent director.

There is a law that deals with relatives. You cannot have a blood relative of somebody as the adviser. Somebody put his uncle on. That should be extended so not just blood relatives but more extended relatives. So, I would do those things.

Chairman SHELBY. Well, what about the brother-in-law and stuff like that?

Mr. FINK. I cannot do enough of that. I can never figure out who is a great-uncle or—but it should be extended beyond parent-child, brother-sister.

I think one thing to think about, though, Senator, are these caused by a breakdown in corporate governance, which I am not convinced, or the lack of the directors' having tools to find out what is going on. I am all for making better corporate governance, but I think here, just reading the newspaper accounts, there were compliance systems and the head of the company said, well, do not count me in the compliance system.

Chairman SHELBY. There are directors, and then there are directors that are involved. Aren't there different types of directors?

Mr. FINK. Yes.

Chairman SHELBY. You can have directors——

Mr. FINK. But they could be 90 percent independent, the brightest men and women ever, but they do not have the tools to find out what is going on. So, I think the most important proposal in my mind is the SEC's proposed compliance rule requiring every fund have a compliance officer—so, I would do that.

The independent chair I am just wary of because it sounds like a magic cure, but only about 20 percent of the industry today have independent chairs.

In Canary, two of the four firms that Mr. Spitzer found had independent chairs, and if my count this morning is right, of the 11 firms total that have been charged by the SEC or the New York Attorney General, four of the 11 have independent chairs. So it sounds good, but I am not sure it does much. And, more importantly, when I speak to good independent directors I know and I say, "Who do you want as your chair? You are a majority, you are two-thirds. You can pick whoever you want." They would prefer a management company person because 90 percent of the matters that come before a fund board are ministerial, administrative, and

the person regularly working there is better putting the agenda together. When they get to a conflict matter between the fund and the adviser, the 1940 Act requires that the inside directors leave the room and only the independent directors be there to decide. They could say rather than an independent chair, I would require that every fund's group of independent directors choose a lead independent director.

I got long-winded, but I am all in favor of two-thirds to three-quarters, tougher definition of independence, compliance officer. I would prefer a lead independent director to a chair. Putting the contract out for bid I think is weird. T. Rowe Price in Baltimore, Mr. Price, decides to go into the money management business, manages rich people's money, foundations, and in 1950, he decides to create T. Rowe Price Growth Fund, spends a lot of money and energy, builds it up. There are directors there to watch out for shareholders, but Mr. Price would not go in the business if any day a T. Rowe Price director said, "Gee, we are going to Fidelity."

And look at us as consumers. Mr. Lackritz and I have lunch. He has $100,000 to invest. We read Morningstar. We do a lot of research. We pick the Fidelity Growth Fund because Joe up there is a great growth fund manager. We do not expect the Fidelity directors tomorrow to say, "We are taking the fund to Putnam."

I said in my testimony before the Committee without jurisdiction, Mr. Chairman, that it is as if I ordered a Chevrolet and a Ford showed up in my driveway. I think we need better directorial control, more fiduciary duties. I am in favor of tougher regulation, as well as sending people to prison. But I think putting the contract out to bid is upside down.

Thank you.

Chairman SHELBY. Mr. Lackritz, a recent report described the multiple problems regarding the granting of breakpoint discount to investors. In response to this report, what actions has the broker-dealer community, your people, taken to ensure that investors receive the discounts to which they are entitled? For example, are brokerage houses considering changes to the way they use omnibus accounts?

Mr. LACKRITZ. I am glad you asked that, Mr. Chairman. When we were first notified about the breakpoint problem by the NASD and the SEC last December, we participated, along with the Investment Company Institute——

Chairman SHELBY. Explain to the audience what a breakpoint problem is.

Mr. LACKRITZ. The breakpoint problem is that mutual funds all have a list of fees in which they will give a discount, if you will, at certain breakpoints. If an investor is investing, say, $50,000——

Chairman SHELBY. Certain amounts.

Mr. LACKRITZ. Certain amounts, that is right, certain threshold amounts. The challenge in this situation is investors sometimes have multiple accounts at different brokerage firms, sometimes deal directly with the fund families themselves. So it is very hard sometimes to aggregate the information operationally to do that.

What the NASD discovered in their inspections and examinations indicated that there was a problem, and so we as an industry organization, along with the Investment Company Institute, jointly

worked with the NASD on a series of measures to both figure out how to organize the information better and how to make sure that investors were getting the breakpoints they deserved, at the same time our firms are in the midst of refunding to all of their investors any breakpoint discounts that they did not receive that they should have received. We are in the midst of getting that done now.

I actually think that the mechanism, this task force on breakpoints that was organized at the behest of the SEC by the NASD, the Investment Company Institute, and the SIA actually was a very good model for addressing a problem fairly quickly, fixing the problem prospectively going forward, and remedying the problem by refunding any overcharges that they found in the past. So, I think it worked very effectively.

Chairman SHELBY. Could you elaborate on how the 4 p.m. cutoff for trade orders would impact the trading activities of investors, such as individuals making changes to their 401(k) funds?

Mr. LACKRITZ. Yes, sir. The proposal that there be a 4 p.m. hard close to the mutual fund itself would mean that an intermediary such as a broker-dealer, or a 401(k) plan administrator more particularly, would have to cut off trading a lot earlier in the day in order to process everything and get it to the fund by 4 o'clock and get it time-stamped. That means that a small investor, like my mother, for example—although I appreciate Mr. Fink's increasing my investment assets earlier—but a small investor like my mother would not be able to trade on information in the marketplace from, say, 2 o'clock to 4 o'clock because the intermediary had to get all the information to the fund by 4 o'clock.

That is why we suggested on the hard close that it would be more effective for investors and much more effective from the standpoint of retirement plan participants, like 401(k) beneficiaries, to have a hard close either at the intermediary, at the broker-dealer, or, alternatively, to set something up with a utility like the NSCC. That idea is in the process of being developed now. That would be fairer to investors, and yet at the same time, we would create an electronic audit trail to make sure that it would not be gamed or evaded by anybody participating in it.

Chairman SHELBY. Gentlemen, we appreciate your appearance and we certainly appreciate your patience today. This has been a long hearing.

On behalf of Senator Zell Miller, who could not be here today, I want to ask unanimous consent that his opening statement and two studies published by two Georgia professors on market timing be placed in the record. Without objection, it is so ordered.

Chairman SHELBY. This hearing is adjourned.

[Whereupon, at 1:25 p.m., the hearing was adjourned.]

[Prepared statements and additional material supplied for the record follow:]

PREPARED STATEMENT OF SENATOR ZELL MILLER

Chairman Shelby, the active trading (market timing) of mutual funds is an issue that we will discuss quite a bit today. Two Georgia professors, Professor Jason T. Greene, from the Business College at Georgia State University and Professor Charles W. Hodges, at State University of West Georgia recently published two studies entitled: "The Dilution Impact of Daily Fund Flows on Open-End Mutual Funds" and "Trading at Stale Prices with Modern Technology: Policy Options for Mutual Funds in the Internet Age."

I would like to commend to the Committee (and ask that both studies be included in the record), these two studies on market timing issues. The first study examines "how mutual fund flows that are correlated with subsequent fund returns can have a dilution impact on the performance of open-end funds and the second study looks at the "economic and regulatory policy issues surrounding stale price trading in open-end mutual funds." And in particular the study looks at "International funds as especially vulnerable to stale price trading because the prices they use to calculate their net asset value (NAV) are often 12 to 15 hours old."

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Trading at Stale Prices with Modern Technology: Policy Options for Mutual Funds in the Internet Age

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Jason T. Greene
Charles W. Hodges

1. Open-end mutual funds offer individual investors many structural advantages over direct investment, including diversification, professional management, and liquidity. The advantages of funds have brought tremendous success to the open-

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end fund industry, but also concern about several issues.[1] Along with their advantages, open-end mutual funds also have structural disadvantages, such as the challenge of pricing shares for sale or redemption.[2] This article examines how technology permits trading to take systematic advantage of the prices offered by funds.

2. Mutual fund portfolio valuation methods often result in a price that offers traders the ability to earn vastly higher returns with no additional risk.[3] Excess returns to traders come at the expense of the fund's buy-and-hold investors. Recent empirical research estimates a wealth transfer from buy-and-hold investors to stale price traders of about a quarter of a billion dollars a year.[4]

3. Ironically, one of the "best" features of open-end funds – seemingly free liquidity – makes the wealth expropriation by stale price traders possible. Mutual funds provide the ability to redeem shares at the next calculated net asset value (NAV) as of the time the order is received, generally 4:00 P.M. Eastern Time in the United States. The benefit of liquidity is that there is usually no direct cost to the investor who purchases or sells shares.[5] To provide this free liquidity feature, open-end funds must set their net asset value daily. This task is problematic because the last trade prices of the fund's underlying assets, which are used in its valuation, are often hours or even days old, hence stale.

4. Funds holding significant amounts of small capitalization domestic stocks or foreign stocks are particularly vulnerable to stale pricing,[6] but other U.S. domestic funds are not immune.[7] With over 10,000 open-end mutual funds, traders who exploit stale prices have a number of targets from which to choose. With the

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[1] *See generally* Arthur Levitt, Keeping Faith with the Shareholder Interest: Strengthening the Role of Independent Directors of Mutual Funds, Speech before the Mutual Funds and Investment Management Conference, (Mar. 22, 1999) *available at* http://www.sec.gov/news/speech/speecharchive/1999/spch259.htm; (paraphrasing from a speech by Chairman Levitt of the Securities and Exchange Commission at The Mutual Funds and Investment Management Conference); *see also* Arthur Levitt, *The Future of Our Markets: Dynamic Markets, Timeless Principles*, 2000 COLUM. BUS. L. REV. 1 (2000).

[2] Open-end fund marketing literature commonly advises investors that equity funds are long-term investments not intended for short-term speculation. *See, e.g.*, AMERICAN CENTURY – WHAT'S BEHIND THE ADVICE WE GIVE, *available at* http://www.americancentury.com/advice/help/help_methodology.jsp#philosophy (last visited Aug. 28, 2001).

[3] *See* John M. R. Chalmers et al., *On the Perils of Financial Intermediaries Setting Prices: The Mutual Fund Wild Card Option*, 56 J. FIN. 2209 (2001).

[4] *See* Jason T. Greene & Charles W. Hodges, *The Dilution Impact of Daily Fund Flows on Open-End Mutual Funds*, 65 J. FIN. ECON. 131 (2002). *See also* Rahul Bhargava et al., *Exploiting International Stock Market Correlations with Open-End International Mutual Funds*, 25 J. BUS. FIN. & ACCT. 765, 765-66 (1998).

[5] *See* Chalmers et al., *supra* note 3, at 2213-18 (noting that in their sample of over 900 funds, about 60 percent have a sales load or transaction fee).

[6] *See generally* Greene & Hodges, *supra* note 4.

[7] *See* Chalmers et al., *supra* note 3, at 2215.

speed and simplicity of trading via modern technology,[8] coupled with institutional arrangements such as fund supermarkets,[9] daily large scale trading based on stale prices offers large benefits at relatively low costs to the traders. Profit opportunities for stale price traders come at the expense of the fund's buy-and-hold investors in the form of dilution[10] and performance degradation.[11]

5. Open-end fund pricing problems are not new. For years, fund families have wrestled with various pricing methods aimed at reducing the opportunities for risk-free trading profits.[12] But the importance of how open-end fund shares are priced has become increasingly critical as funds have become easier to trade. Rather than using regular ("snail") mail for fund purchase or redemption requests, investors can now rely on high-speed communication technology, including the Internet, to trade funds on a daily basis. The explosive growth of technology that facilitates the stale price trading of open-end funds has brought significant policy challenges to fund families and regulators.

6. In Part I, this article examines the stale pricing problem. Part II reviews the rules for open-end fund pricing and sets the controversy of fund pricing in historical perspective. Part III explores the options for addressing stale prices, dividing them into *ex ante* policies, i.e. pricing rules,[13] or *ex post* policies, imposing restrictions on trading or costs for liquidity.[14] Part IV reviews the regulatory actions that have been taken to address stale price trading and recommends two refinements to the current policy. Part V concludes.

I. Understanding the Stale Pricing Problem

A. An Example Using International Funds

7. It is possible to illustrate a stale-price trading strategy with an example from an international fund. Such a fund is domiciled in the U.S. but invests in international stocks. Consider the timeline for trading in markets around the globe: the first markets to open after a weekend are the Asian and Pacific markets, such as Tokyo, Hong Kong, and Sydney. The next markets to open are the European trading centers in Germany, France, and the United Kingdom.[15] Finally, the U.S., Canadian, and Latin American markets begin trading. By the time trading

[8] For a more complete discussion of the technological advances in securities markets, *see* Paul D. Cohen, *Securities Trading Via the Internet*, 4 STAN. J.L. BUS. & FIN. 1 (1999).
[9] Schwab One Source is one of a growing number of 'fund supermarkets' that allow the trading of hundreds (or even thousands) of different funds through one channel.
[10] *See* Greene & Hodges, *supra* note 4, at 144-147.
[11] *See* Roger M. Edelen, *Investor Flows and the Assessed Performance of Open-End Mutual Funds*, 53 J. FIN. ECON. 439 (1999).
[12] *See* Chalmers et al., *supra* note 3, at 2216-20.
[13] *See id.* at 2219-21.
[14] *See* Greene & Hodges, *supra* note 4, at 148, 149.
[15] *See generally* M. Copeland & T. Copeland, *Leads, Lags, and Trading in Global Markets*, 54 FIN. ANAL. J. 70, 72 (1998).

commences in New York, the Asian markets have closed, but most European markets continue trading. By 11:30 A.M. in New York, most of the European markets have closed.[16]

8. Despite the timing of trading in the underlying (international) stocks held by the U.S. domiciled mutual fund, shares in the fund itself trade only once per day, at 4:00 P.M. Eastern Time. Under the current rules, the value of each asset in the portfolio is usually determined by its last trade price in its home market.[17] At 4:00 P.M. Eastern Time, when U.S. markets close, many of the world's financial markets last traded several hours earlier. For Japanese stocks, the last trade of the day occurred hours prior to when the trading *began* in New York. For European stocks, the last trade price occurred prior to noon in New York. Therefore, the prices used to calculate the NAV of U.S.-based international mutual funds are "stale." Stale prices cannot reflect price-relevant information that is "released" or revealed subsequent to the asset's last trade.[18]

9. What type of information could be released after foreign markets close? One pattern that might constitute valuable information is the association between the value changes among markets. Financial research has established that movements in the U.S. market tend to lead to movements in other markets.[19] For example, suppose the U.S market experiences a sharp movement up on Monday afternoon. Because of the positive correlation between the U.S. market and foreign markets, the Asian markets can be predicted to increase once they begin trading (their next day). Following suit, the European markets are likely to move up as their markets open.

10. Predictability in next-day price changes normally is not exploitable by trading foreign shares themselves because those shares tend to re-price the instant trading resumes the next day. However, traders can exploit the pricing of U.S. domiciled mutual funds that hold foreign shares because these funds are not re-priced in response to information that has not yet been traded upon. Valuation of fund shares using stale prices thus leads to a profitable mutual fund trading strategy.

11. The stale price trading strategy is to buy (i.e., exchange into) international mutual

[16] *See id.* There are some exceptions. *See* Vincent Boland, *Trading Fad Leaves Dealers with Time on Their Hands*, FIN. TIMES, May, 29, 2000, at 19 (noting that Milan and Frankfurt Bourses extended the close of their trading day to 1830 GMT in May and June of 2000).

[17] *See* Accounting Series Release No. AS-118 [1937-1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶72,140 (Dec. 23, 1970).

[18] *See* Chalmers et al., *supra* note 3, at 2220.

[19] *See, e.g.*, Kent G. Becker et al., *The Intertemporal Relation Between the U.S. and Japanese Stock Markets*, 45 J. FIN. 1297 (1990); Alastair Craig et al., *Market Efficiency Around the Clock: Some Supporting Evidence Using Foreign-Based Derivatives*, 39 J. FIN. ECON. 161 (1995); Cheol Eun & Sangdal Shim, *International Transmission of Stock Market Movements*, 24 J. FIN. & QUANT. ANAL. 241 (1989); Yasushi Hameo et al., *Correlations in Price Changes and Volatility Across International Stock Markets*, 3 REV. FIN. STUD. 281 (1990); Mervyn King & Sushil Wadhwami, *Transmission of Volatility Between Stock Markets*, 3 REV. FIN. STUD 5 (1990); Wen-Ling Lin et al., *Do Bulls and Bears Move Across Borders? International Transmission of Stock Returns and Volatility*, 7 REV. FIN. STUD 507 (1994).

funds on days when the U.S. market moves up and sell (exchange out of) international mutual funds on days when the U.S. market moves down. This strategy yields higher returns with lower risk than a "buy and hold" investment strategy.[20] The large profits at relatively low risk are quite attractive to almost any investor.[21] Moreover, the strategy is easily implemented; trade once per day, just prior to the close of U.S. equity markets. Mutual fund trades or exchanges can be transacted through the Internet and/or by automated telephone programs at most fund families.[22]

B. Stale prices in domestic funds?

12. Even though this article illustrates a stale-price trading strategy by using a U.S. domiciled fund that holds foreign stocks, the scope of this problem (or opportunity, depending upon the perspective) is not limited to funds that hold stocks in non-U.S. markets. Profitable stale-price trading strategies also exist in domestic equity funds.[23] Stale prices in domestic funds result from the fact that many stocks do not actively trade. Inactive stocks' last trade prices, on which funds base their NAV, are potentially stale relative to what they would otherwise be if the stocks were actively traded.

13. Financial research has established that small company stocks tend to trade infrequently compared to large company stocks.[24] To illustrate the effect of this phenomenon, return to the example where the U.S. market experiences a strong move up in afternoon trading. Assuming that a small company stock traded early in the day and did not trade subsequently, that stock's last recorded trade price would not reflect the strong market move upward. Because mutual funds use the stock's last traded price for valuation purposes, the end-of-day NAV will be stale relative to the information available near the end of the trading day.[25] The more concentrated a mutual fund is in stocks that do not trade frequently, the more severe this problem. Therefore, the stale-price trading strategy has the greatest profit potential among the domestic funds that hold small company stocks.

14. Empirical research suggests that domestic stale pricing strategies are not as

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[20] *See* Chalmers et al., *supra* note 3, at 16.
[21] *See* Mindy Charski, *Latest Mutual Fund Game: Buy and Dump*, U.S. NEWS & WORLD REP., May 24, 1999, at 74 (comparing the rapid trading of funds to that of individual stocks (day trading)).
[22] *See, e.g.*, Kimberly Weisul, *Charles Schwab Offers Trading of Mutual Funds on Web Site*, INVESTMENT DEALERS' DIG., July 22, 1996, at 9. In 1996, Schwab began offering trading capability for over 1000 funds over the Internet to complement the ability to trade funds over the telephone, or in branch offices; *see id.*
[23] *See* Chalmers et al., *supra* note 3, at 16; *see also*, Eric Zitzewitz, *Daily Mutual Fund Net Asset Value Predictability and the Associated Trading Profit Opportunity* (Feb. 2000) (unpublished manuscript, on file with the author).
[24] *See, e.g.*, Andrew Lo & A. Craig MacKinley, *An Econometric Analysis of Nonsychronous Trading*, 45 J. ECONOMETRICS 181 (1990).
[25] *See* Chalmers et al., *supra* note 3, at 14. The trading time lag for small capitalization domestic versus large capitalization domestic stocks is typically shorter than that for international stocks (especially Asian) versus U.S. stocks; *see id.*

profitable as international strategies.[26] In addition, there is no current evidence that traders actually exploit the profit potential of domestic funds.[27] One explanation is that stale price traders are focusing on international funds where the profit potential is generally higher.

15. But U.S. funds might become attractive targets for exploitation. The degree of correlation between the U.S. market return and the return on the non-traded asset figures heavily in stale price trading profitability.[28] Small-capitalization domestic stocks – particularly those with a high market risk (beta) – are far more correlated with the U.S. market trigger than international assets.[29] Exploitation of domestic-fund pricing errors might grow, especially if evidence of the profitability of stale-price trading strategies becomes more generally known.

C. Dilution Effect

16. Profits from stale-price trading strategies come at the expense of the non-trading mutual fund shareholders. The transfer of wealth from the passive (non-trading) mutual fund shareholders to the traders occurs through "dilution."[30] Stale-price traders buy (sell) shares of the mutual fund just prior to positive (negative) returns in the fund. The fund manager cannot invest (liquidate) the cash from the stale price trader prior to the predictable next-day follow-through return in the underlying stocks. Indeed, to avoid this dilution the fund manager would have had to complete the investment (liquidation) of cash prior to the underlying stocks' last trades. In the case of Asian assets, that means that the fund manager must invest (liquidate) some thirteen hours *prior to* knowing what trade is needed! Therefore, the fund's cash position increases (decreases) just prior to and during positive (negative) returns on the fund's stock holdings. This dilutes the fund's positive returns to be lower than they would have been had the cash flows not been present. Exhibit 1 provides a numerical illustration of the effect.

17. ***Exhibit 1 - Dilution Example***

Fund A (without fund flows)		**Fund B (with dilutive fund flows)**	
Time 0		**Time 0**	
Risky Assets	**$100**	**Risky Assets**	**$100**
Cash	**$0**	**Cash**	**$10**
Total Assets	**$100**	**Total Assets**	**$110**
Shares outstanding	**10**	**Shares outstanding**	**11**

[26] *See* Chalmers et al., *supra* note 3, at 2215-18.
[27] *See* Greene & Hodges, *supra* note 4, at 2217-19.
[28] *See id.* at 10-12.
[29] *See* Chalmers et al., *supra* note 3, at 2212-13.
[30] *See* Greene & Hodges, *supra* note 4, at 14-16.

NAV per share	**$10.00**	**NAV per share**	**$10.00**
Time 1		**Time 1**	
Risky Assets	**$110**	**Risky Assets**	**$110**
Cash	**$0**	**Cash**	**$10**
Total Assets	**$110**	**Total Assets**	**$120**
Shares outstanding	**10**	**Shares outstanding**	**11**
NAV per share	**$11.0000**	**NAV per share**	**10.9091**
NAV Return	**10.00%**	**NAV Return**	**9.09%**
		Dilution	**-0.91%**

18. This exhibit shows two mutual funds. Both funds hold identical risky assets that offer a return of 10% between time 0 and time 1. Fund B issues one new share at time 0, resulting in $10 of cash and one additional share outstanding compared with Fund A. Under the assumption that Fund B cannot invest the cash in risky assets between time 0 and time 1, Fund B experiences a negative impact from dilution.

19. With enough active traders, this dilution effect can be both noticeable and statistically significant. Empirical estimates from a sample of about twenty-percent of the international funds available to U.S. investors suggest that in the twenty-six-month period from February 1998 through March 2000, the transfer of wealth from passive fund shareholders to stale price traders was about $420M.[31] Assuming that this sample is representative of the universe of international funds, the transfer of wealth over that two-year period exceeded one billion dollars.[32] The average international fund's return was decreased by nearly fifty basis points per year from the dilution caused by stale-price trading.[33]

20. While passive shareholders in international funds are currently losing significant profits to active traders through dilution, the potential for wealth transfers exists in some domestic funds as well.[34] Shareholders in domestic funds are seemingly safe for the moment, only because they are not quite as attractive targets to the active traders. However, these shareholders are nonetheless in jeopardy. If the problem of stale prices is addressed in international funds, but not in domestic

[31] *See id.* at 16-17.
[32] *See id.* at 21.
[33] *See id.* at 16.
[34] *See* Chalmers et al., *supra* note 3, at 2213-15.

funds, the active traders can be expected to shift their attention to raiding domestic funds. Any self-regulatory or governmental policies must therefore address dilution effects in both international and domestic funds.

D. Performance Effect

21. In addition to the dilution effects, stale price trading hurts buy-and-hold shareholders by hampering the fund's operations. Managers of open-end funds that experience high levels of inflows and outflows transact less efficient orders.[35] The Montgomery Emerging Asia Fund provides an interesting example. On a single day in 1998, the fund experienced seven million dollars in inflows.[36] After capturing short-term profits, these inflows quickly reversed, forcing the fund manager to liquidate investments to meet the fund's redemption requests.[37]

22. Those investors who buy the fund's shares and hold for longer terms bear the burden of the performance costs of the "free" liquidity offered by the fund.[38] Sadly for these patient shareholders, the funds where prices are the most stale and where dilution by stale price trading is the most attractive are also those funds where stale price trading would most greatly harm fund operations. International and small capitalization stocks tend to be the most expensive to trade.[39] The threat of having to sell recently purchased positions (or *vice versa*) drives managers to hold more cash.[40] Stale price trading thus costs buy-and-hold shareholders in two ways – dilution and performance degradation.[41]

II. Rules for Open-End Fund Pricing

23. Recent technological advances such as the Internet have created new challenges for funds by facilitating the stale-price trading of their shares. This article argues that the SEC should consider changes in policies to address these trading opportunities. The suggested policy innovations are not the first to be made regarding the pricing of open-end fund shares, however. To place the current policy recommendations in context, this section offers an historical perspective on the evolution of open-end fund pricing.

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[35] *See* Edelen, *supra* note 11, at 442.
[36] *See* Charski, *supra* note 21, at 74. The fund had $30M in total assets at the time; *see id.*
[37] *See id.*
[38] *See* Greene & Hodges, *supra* note 4, at 1.
[39] These stocks would tend to have the high bid-ask spreads due to low volume of trading and high risks of market making relative to large-cap U.S. stocks.
[40] *See* Aaron Lucchetti, *Frequent Trading Worries Fund Firms*, WALL ST. J., Sept. 20, 2000, at C1 (quoting Paul Schatz, President of the Society of Asset Allocators and Fund Timers). Trading in and out of international funds is "...an awful way to make money. The other [non-trading] shareholders get left with the loss..." because frequent trading forces the manager to trade more stocks and hold more cash to deal with quick moves. *Id.*
[41] *See id.* at C19 (quoting Ralph Wanger, manager of Acorn Fund and head of Wanger Asset Management, confirming that his international fund has been forced to increase cash holdings in the face of increased trading).

A. Historical Perspective on Mutual Fund Pricing

24. The challenges associated with pricing date back over seventy-five years to the birth of mutual funds in 1924.[42] The first of what would later be called open-end mutual funds was the Massachusetts Investors Trust, which opened in March 1924.[43] In August 1924, State Street Investment Corporation became the second open-end fund,[44] followed in November 1924 by Incorporated Investors, which was later renamed Putnam Investors Fund.[45] While these three funds differed in several ways, each contained two common innovations that became unique to the open-end structure and critical to pricing the claims on fund shares.[46] The first innovation was a self-liquidating feature, which allowed investors to redeem their shares directly with the mutual fund company in exchange for cash.[47] The second was a simple all-equity capital structure consisting only of a single class of equity securities.[48]

25. Initially, the closed-end mutual fund and other investment company forms had greater success than open-end funds. By 1929, open-end funds contained only two percent of total mutual fund assets.[49] With the market crash of 1929 and the following Great Depression, however, the open-end mutual fund, which continuously offers shares to the public and allows investors the opportunity to

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[42] *See* WILLIAM J. BAUMOL ET AL., THE ECONOMICS OF MUTUAL FUND MARKETS: COMPETITION VERSUS REGULATION 27 (1990); *see also Protecting Investors: A Half Century of Investment Company Regulation by Division of Investment Management*, United States Securities and Exchange Commission, U.S. Government Printing Office, May 1992, at 422 (noting that with the passage of the Investment Company Act of 1940, 15 USC § 80a-5, funds were limited to either open-end or closed-end status – the act defined a closed-end company as any company other than an open-end company).
[43] *See A Study of Mutual Funds, Prepared for the Securities and Exchanges Commission,* Wharton School of Finance and Commerce, U.S. Government Printing Office, Washington (1962) at 37; *see also* W. H. STEINER, INVESTMENT TRUSTS: AMERICAN EXPERIENCE 208 (1929) (arguing that beyond being the first open-end fund, this Investment Company was unusual in that it gave the investors some control over the selection fund management in that members elected a president that then approved the choice of Trustee. Most Trusts during this era had a self-perpetuating management that could not be changed by the investors).
[44] *See* Clive Runnells, *The Past, The Present and the Future, in* HOW TO START, OPERATE, AND MANAGE MUTUAL FUNDS (Lucile Tomlinson, ed., 1971) at 7.
[45] *See id.*
[46] *See* Steiner, *supra* note 43, at 209 (citing the Incorporated Investors fund, which originally had a 15-year term after which the fund would be liquidated); *see also* Runnells, *supra* note 44, at 7.
[47] *See A Study of Mutual Funds, Prepared for the Securities and Exchange Commission, supra* note 43, at 37 (citing as an example the Massachusetts Investors Trust redeemed shares at Net Asset Value minus two dollars per share); *see also* Steiner, *supra* note 43, at 55-59 (commenting that prior to this time, some funds did allow investors to exchange their Investment Company shares for the underlying securities held by the Investment Company. This type of fund was known as a Banker's Share Company). *See id.* at 221. These shares were normally non-transferable. Thus investors could only sell their shares to the Investment Company. *See id.*
[48] *See* Runnells, *supra*, note 44, at 7. *See generally* Steiner, *supra* note 43. The single equity security was not so much an innovation, but rather a unique feature. The normal capital structure for Investment Companies/Trusts of the period was to have several debt/bond issues and multiple classes of equity. *See id.*
[49] *See A Study of Mutual Funds, Prepared for the Securities and Exchange Commission, supra* note 43, at 37.

redeem their shares on demand at NAV, became a preferred vehicle.[50] A key to investors' preference for the open-end structure was that other types of Investment Companies depended upon market forces to set their share prices. Closed-end shares, for example, often sold at a large discount to the value of the portfolio's underlying securities and sometimes these funds had no investors willing to set a price at which others could buy.[51]

B. Mutual Fund Mis-pricing

26. The pricing of open-end mutual fund shares (necessary any time fund shares are issued or redeemed) troubled funds and state regulators from the birth of open-end funds in the 1920s.[52] If the calculated NAV were to deviate systematically and predictably from the value of the fund's underlying assets, fund traders could dilute the returns of buy-and-hold investors.[53] The pricing issue became a problem for federal regulators with the passage of the Investment Company Act of 1940.[54]

27. Potential mis-pricing of open-end mutual fund shares is largely related to three accounting issues.[55] Because they continuously sell and redeem shares, open-end mutual funds must calculate their balance sheet in two stages.[56] In the first stage, the fund determines or estimates the market value of the fund's holdings and then divides that by the number of outstanding shares to determine the NAV. In the second stage, the fund sponsor uses the NAV to record any redemptions or purchases. The three accounting issues that impact pricing are: (1) the decision as

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[50] *See* Steiner, *supra* note 43, at 221-22 (describing that, in writing prior to the passage of the Investment Company Act of 1940, Steiner simply calls the price at which these funds would redeem shares the "redemption price" or "cash value of participation.") This redemption price was calculated in the same manner as net asset value. The term net asset value was not generally used until around the time of the passage of the Investment Company Act of 1940. This article uses the term Net Asset Value to describe the price at which an open-end mutual fund either sells or redeems shares for both the pre-1940 and post-1940 time frames. *See id.* at 222. *See generally* 15 U.S.C. § 80a-5(a)(1) (1994) (defining an open-end company as "a management company which is offering for sale or has outstanding any redeemable security of which it is the issuer").

[51] *See A Study of Mutual Funds, Prepared for the Securities and Exchanges Commission, supra* note 43, at 37-39.

[52] *See* BAUMOL ET AL., *supra* note 42, at 49-52, (reviewing some of the pre-1940 problems). *See generally* Steiner, *supra* note 45 (discussing accounting issues in the early American Investment Trusts).

[53] *See* Greene & Hodges, *supra* note 4, at 8-14. The deviation must be both predicable and systematic in order for traders to exploit the mispricing. Predictability allows the trader to know "whether" to buy or to sell. Systematic permits the trader to know "when" to buy or sell. *See id.*

[54] *See* Steiner, *supra* note 43, at 301-18 (reviewing state level regulation of Investment Companies in the 1920's).

[55] Accounting Series Release No. AS-118 [1937-1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶72,140 (Dec. 23, 1970) governs the valuation of securities within a fund.

[56] Per the Investment Company Act of 1940, this calculation must be at least daily. *See* ROBERT C. POZEN, THE MUTUAL FUND BUSINESS, MIT PRESS 474-482 (1996). Since the beginning of the open-end mutual fund, the sales of mutual fund shares, especially front-load funds, were typically contracted out to a "principal underwriter." The accounting for sales and purchases is often contracted to a "transfer agent." *See id.; see also* UNITED STATES SECURITIES AND EXCHANGE COMMISSION, *supra* note 42, at 291-92 (noting that prior to the Investment Company Act of 1940, some open-end funds suspended redemption privileges).

to when the newly calculated NAV becomes effective (Stage 2); (2) whether all investors are required to sell and redeem at the NAV (Stage 2); and (3) the method of determining the market value of the financial securities held by the mutual fund (Stage 1).

28. At various times prior to the passage of the 1940 Act, abuses of these three accounting issues were common. In some cases, a mutual fund would arbitrarily suspend the redemption privilege.[57] The funds often justified this action on the basis of charter documents that were not routinely distributed to shareholders.[58] Motives for the suspension of redemption rights included net redemptions exceeding net purchases, redemptions reducing net assets (and therefore management fees), and prevention of shareholders switching to other funds.[59]

29. Another common accounting manipulation led to "dual pricing."[60] Historically, funds calculated NAV as of the close of the New York Stock Exchange. However, before the passage of the 1940 Act, a fund would not publish the NAV until the next morning at 10 A.M. Eastern Time.[61] Thus from the market close until 10 A.M. the following day, two prices would effectively exist. Fund insiders and large investors, who were allowed to buy and sell without paying a load, could create a riskless arbitrage by simultaneously buying at the low price and selling at the high price.[62] This riskless arbitrage significantly diluted the holdings of buy-and-hold investors.[63]

30. A similar abuse occurred when different investors paid different prices for shares.[64] Differential pricing was due to the "bootleg" secondary markets outside of the fund family. In these markets, brokers who were not fund underwriters would quote buy and sell prices that were "inside" the redemption and offering prices set by the mutual fund company.[65] In some cases, fund outsiders could use this secondary market to create arbitrage opportunities.[66] Sales of shares at different prices also occurred inside fund companies.[67] In this case, some insiders were allowed to purchase their shares at a discount to NAV, while external purchasers bought at NAV plus a commission (front-load).[68]

[57] *See id.* at 427-428. Under 15 U.S.C. § 80a-22(c) (1994), the SEC has broad authority to regulate the price a shareholder will receive upon redemption. Section 22(e) prohibits the suspension of the redemption privilege and requires redemption within 7 days. *See id.*
[58] *See id.*
[59] *See id.*
[60] *See* BAUMOL, ET AL., *supra*, note 42 at 51.
[61] *See id.*
[62] *See* UNITED STATES SECURITIES AND EXCHANGE COMMISSION, *supra* note 42, at 300-01.
[63] *See generally* 15 U.S.C. § 80a-22(d) (1994). This riskless arbitrage was specifically outlawed by Section 22(d) of the Investment Company Act of 1940. *See id.*
[64] *See* UNITED STATES SECURITIES AND EXCHANGE COMMISSION, *supra* note 42, at 301-04.
[65] *See id.* at 302-03.
[66] *See id.* at 302.
[67] *See id.* at 301.
[68] *See id.* at 303.

C. Forward Pricing versus Backward Pricing

31. The 1940 Act eliminated price discrimination, but the potential for dilution continued. From the passage of the 1940 Act until 1968, the pricing norm was to calculate a NAV that remained in effect for the next twenty-four hours.[69] Thus, most funds calculated NAV *prior* to the point in time when they offered investors the ability to purchase or redeem shares.[70] Backward pricing, as it was known, created stale prices.[71] Backward pricing presented investors (or their aggressive brokers) with the opportunity to make large speculative profits by purchasing large blocks of fund shares during a rising market and selling the shares quickly after the NAV was recalculated to reflect the market's rise.[72] Successful implementation of this strategy resulted in dilution for the fund's buy-and-hold shareholders.

32. Responding to what it perceived to be widespread abuses that resulted from backward pricing, the Commission adopted Rule 22c-1 in 1968.[73] Section 22(c) of the Investment Company Act of 1940 and Rule 22c-1 instruct mutual funds as to how to calculate their net asset value (NAV).[74] Reversing what had been the norm (backward pricing), Rule 22c-1 requires funds to adopt a forward pricing rule in which they sell or redeem shares at the NAV that is first computed *after* the order is received.[75]

D. Fair Value Pricing

33. For the purposes of calculating value, Section 2(a)(41) of the Investment Company Act of 1940 divides securities into two classes.[76] Where securities have "readily available" market quotations, "current market value" should be used.[77] Current market value is generally accepted to be a security's last quoted sales price on a national exchange.[78] Where securities do not have a "readily available" market quotation, "fair value" should be used.[79] The fund's board of directors has the power to determine "fair value" in good faith.[80]

[69] *See id.* at 292-293.
[70] *See* Barry Barbash, ***Remembering the Past: Mutual Funds and the Lessons of the Wonder Years***, ICI Securities Law Procedure Conference, Dec. 4, 1997, at 1-2.
[71] *See id.*
[72] *See id.*
[73] *See id.*
[74] *See* 15 U.S.C. § 80a-22(c) (1994); 17 C.F.R. § 270.22c-1 (1999).
[75] *See id.* § 270.22c-1
[76] *See* 15 U.S.C. § 80a-2(a)(41) (1994).
[77] *See id.*
[78] *See* Accounting Series Release No. AS-118 [1937-1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶72,140 (Dec. 23, 1970).
[79] *Id.*
[80] *Id.* (No single standard for computing "fair value" exists. But as a general principle, it is thought of as the amount that an "owner might reasonably expect to receive [for the fund shares] upon their current sale." *Id.*)

34. Two issues complicate the determination of fair value. First, there are no clear standards for when "fair value" should be applied. The second problem consists of determining fair value in the event it should be applied.[81] The lack of uniformity creates problems in the pricing of funds. These problems are especially severe in funds that hold foreign securities.[82]

35. Pricing issues come to the forefront during times of large market moves. During October 1997, for example, Asian markets were undergoing severe turbulence. On Tuesday, October 28, 1997, the Hong Kong market index declined about fourteen-percent, following the previous day's decline on the New York Stock Exchange. Later on Tuesday, October 28, the New York market rallied. United States funds holding Hong Kong securities were now faced with a dilemma.[83] Should they invoke "fair value" rules? Some did not, instead choosing to compute NAV from the Tuesday closing prices in Hong Kong.[84] Other fund families, such as Fidelity, concluded that the closing prices in Hong Kong did not represent "fair value" and calculated their funds' NAV based on another method.[85]

E. Current Guidance

36. Largely as a result of the Asian crisis in 1997, the SEC undertook a series of actions to clarify some aspects of open-end mutual fund pricing. In a 1998 review, the Commission restated that its fundamental regulatory tenets would continue to be forward pricing, the use of market quotations for NAV computation, and the use of fair value pricing under some circumstances.[86]

37. On this third tenet, the Commission took several actions aimed at addressing the criticism from investors about the use of fair value pricing.[87] Funds must use plain English to discuss pricing, include a statement that explains the impact of fair value pricing, and discuss the circumstances under which fair value pricing might

[81] Thomas Ogden & Cindy O'Hagan, *Mutual Funds Confront Dilemmas in Trying to Value Portfolios: SEC Needs to Provide Updated Guidelines*, N.Y.L.J., Dec. 7, 1997, at 7.
[82] *See id.*
[83] *See* 17 C.F.R. § 270.22c-1 (1999). Large price swings that roil through markets in sequence present an opportunity to view this issue clearly. One irony that appears is that stale prices essentially result in backward pricing. The fund is setting the NAV *prior* to when investors make orders *if* the prices it uses to set NAV are stale. So despite the forward pricing reforms (Rule 22c-1), the perils of backward pricing remain.
[84] *See id.*
[85] Edward Wyatt, *Mutual Funds: What's Fair in Fund Value?* N.Y. TIMES, Nov. 9, 1997, § 3, at 12 (citing Fidelity's attempts to extrapolate value from analyzing securities in New York with links to securities in Hong Kong).
[86] *See* Barbash, *supra* note 70, at 7-8.
[87] *See* Ogden & O'Hagan, *supra* note 81 (A number of investors who had expected to profit from the large price swings in the Asian Market complained to the SEC when fund families such as Fidelity invoked fair value pricing).

be employed.[88] Such discussion must be included on the mutual fund registration form N-1A.[89]

38. Even after the 1998 review, however, the nagging issue of what actually constituted a trigger for fair value pricing remained.[90] The Commission subsequently came forward with correspondence addressing this issue and tying the use of fair value pricing to a "significant event."[91] In a letter sent by Chief Counsel Scheidt to counsel for the Investment Company Institute (ICI) on December 8, 1999, the SEC argued that the 1940 Act required fund boards to determine the fair value of securities in several circumstances.[92] When the market on which the security is traded, for example, does not open for an entire trading day, the market quotations for the security are not "readily available" and fair value pricing is appropriate.[93] Merely concluding that a market quotation is not readily available, however, does not preclude a board from using the market closing price for a security.[94] Fund boards were also advised to consider the nature and duration of the event impacting the market or security.[95] Part of that evaluation includes trading volumes, values of derivative securities, government announcements, and currency trading.[96]

39. In an April 30, 2001 letter to the ICI, the SEC went even further to address fair value pricing.[97] The Commission argued that a fund board *must* use fair value pricing if a significant event (one that would affect the value of a portfolio security) has occurred since the closing of a foreign market but before the NAV calculation.[98] The letter indicates that such an event could be related to a single issuer or an entire market, or could be linked to a natural disaster, armed conflict, or significant government action.[99] The 2001 letter also focused more on the market timing issues associated with stale prices, observing that the Asian markets are open during the evening in the United States.[100]

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[88] SEC Release No. 33-7512; 34-39748: IC 23064, *Final Rule: Registration Form Used by Open-End Management Investment Companies*, SEC Release Nos. 33-7512; 34-39748: IC 23064; File No. S7-10-97, 17 C.F.R. 230, 232, 239, 240, 270, 274 (June 1, 1998). [hereinafter SEC Release].
[89] *See id.*
[90] *See* Barbash, *supra* note 70, at 7-8.
[91] Letter from Douglas Scheidt, Associate Director and Chief Counsel of the Securities and Exchange Commission, to Craig Tyle, General Counsel of the Investment Company Institute (Dec. 8, 1999), *available at* http://www.sec.gov/divisions/investment/guidance/tyle120899.htm [hereinafter SEC letter].
[92] *See id.*
[93] *See id.*
[94] *See id.*
[95] *See id.*
[96] *See id.*
[97] Letter from Douglas Scheidt, Associate Director and Chief Counsel of the Securities and Exchange Commission, to Craig Tyle, General Counsel of the Investment Company Institute (Apr. 30, 2001), *available at* http://www.sec.gov/divisions/investment/guidance/tyle043001.htm [hereinafter SEC letter].
[98] *See id.*
[99] *See id.*
[100] *See id.*

III. How Can the Stale Price Problem Be Addressed?

40. This section examines the approaches to address the expropriation of shareholders' wealth from stale price trading. *Ex ante* policies aim at addressing the stale-price problem itself. The term *ex ante* refers to the goal of correcting the pricing problem *before* stale price traders have a chance to take advantage of stale prices. Conversely, *ex post* policies do not attempt to correct the stale price, but rather focus on balancing the interests of those that trade and those that do not trade. One example is to charge traders a transaction fee to compensate passive fund shareholders for the costs that trading imposes on the fund, such as dilution and performance degradation.

A. *Ex ante* approaches

41. The strategy of using stale prices to earn abnormally high profits stems from the ability to predict changes in NAV. The direct way to eliminate the problem is to change the way that NAV is set. Particular to U.S. funds, fund sponsors need a NAV-setting algorithm that makes subsequent NAV changes unpredictable given all public information available to investors at 4:00 P.M. Eastern Time. This section discusses the feasibility and problems associated with such an approach.

42. Closing (last trade) prices of stocks often do not produce NAV with the desired property of unpredictable subsequent changes.[101] Any algorithm with this property must therefore *impute* a value to stocks where no trading has yet occurred – a challenging proposition. Unless the rule is objective and mandatory, advisors run the risk of appearing arbitrary when they invoke special rules or models.[102] Moreover, the rule itself runs the risk of being gamed, or presenting an unfair trading environment to certain investors.[103]

43. How might such a rule work in practice? Empirical work has put sufficient structure on the source of valuation errors to guide the development of potentially effective solutions. One procedure uses the midpoint of the stock's bid and ask quote (as opposed to an actual trade price) to compute NAV.[104] A second approach is to scale the price of any stock that has not recently traded according

[101] *See* Chalmers et al., *supra* note 3, at 2219-2223. Closing prices might be "stale," as in the case of international funds, or funds might be holding domestic securities that are thinly traded, or even restricted from trading.
[102] *See* Ogden & O'Hagan, *supra* note 81. (observing that both Fidelity and T. Rowe Price chose to invoke fair value pricing following the large rebound in the U.S. market on October 28, 1997. Traders had pumped nearly $20M on October 28 into one Fidelity fund heavily invested in Hong Kong expecting the Asian markets to rally upon their opening).
[103] *See* Ogden & O'Hagan, *supra* note 81, at 7 (arguing that invoking fair value pricing balances the interests of long-term and short-term shareholders). "The lack of accurate quotations due to market dislocation raises difficult issues concerning a fund manager's obligations to short-term and long-term investors. Whereas strict adherence to highly volatile dealer quotes might serve the interests of investors seeking to trade on market disruptions, consideration of underlying 'fair values' might often be the best way to protect long-term holders against dilution of a fund's assets." *Id.*
[104] *See* Chalmers et al., *supra* note 3, at 2219-23.

to market moves during the non-trading period.[105] Using quotes does little to deter stale price trading, but "market-updating" does reduce the correlation between fund returns and lagged market returns.[106] From these empirical results, it appears that "fair value pricing" rules might have the potential to curtail the expropriation of wealth by stale price traders.[107]

44. A simpler approach would be to offer the shares at the NAV computed on the day *after* the order requests are received. For example, an investor making a buy order at 3:55 P.M. on Tuesday would have his or her order executed at the NAV computed at 4:00 P.M. on Wednesday. While this certainly has the potential to reduce the staleness of prices, research has suggested that it would not eliminate dilution.[108]

45. *Ex ante* pricing rules have a major advantage – they impose no cost on shareholders who trade fund shares for exogenous reasons, such as a liquidity need or a desire to change one's asset allocation. As long as the rules are well published and effective, it would seem that they would deter trading of fund shares that was motivated by the (now defunct) stale price.

46. Note that an *ex ante* pricing rule is really a contracting solution. The fund manager does not know the 'true' valuation of the assets held until they next trade. If the fund manager uses a pricing rule or algorithm to determine value, then the fund will have to spell out the policy in advance to shareholders, probably with a warning period. Investors would then be free to accept the policy or leave the fund. Under one fair value pricing method, the typical alternation of price for domestic funds is about three to five cents.[109] Assuming that the average fund trades at about thirty dollars per share, this equates to about ten basis points (0.1%). Moreover, the algorithm is just as likely to lower, as it is to raise NAV relative to the closing-price algorithm, so no bias obtains.[110]

47. But, fair value pricing is arguably not true pricing because there is no transaction validating that price.[111] Validation thus amounts to a battle of pricing models. Using models could bring about claims of arbitrary pricing. For example, when is fair value pricing to be employed? If only on certain days, then what are triggering events?[112] Despite the regulatory suggestions, it might be difficult to

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[105] *See id.* at 2220.
[106] *See id.* at 2222.
[107] *See id.*
[108] *See* Jacob Boudoukh et al., *The Last Great Arbitrage: Exploiting the Buy-and-Hold Mutual Fund Investor* (unpublished manuscript, on file with the author).
[109] *See* Chalmers et al., *supra* note 3, at 2223. Although the exact magnitude of the correction for international funds remains an empirical issue, it is likely that the adjustment would be similar to that for domestic funds.
[110] *See id.* at 2221.
[111] *See id.* at 2220. The joint-hypothesis problem in asset pricing is due to not knowing the true price. Researchers must assume a pricing model to test whether prices conform to that model. *See id.*
[112] If markets in the Asian region close for a day due to weather, for example, would that constitute a triggering event?

describe when fair value pricing would be employed in advance of the actual usage.[113] It would seem that the fair value algorithm would need to be applied indiscriminately every day. Even without claims of arbitrariness, applications of fair value pricing could confuse investors and turn them away from open-end funds.

B. *Ex post* approaches

48. Unlike *ex ante* policies, *ex post* approaches make no attempt to adjust a stale NAV *before* investors are able to trade to take advantage of it. Instead, *ex post* policies take effect *after* a trade (presumably at a stale price) has been made.[114] These policies are a contracting solution whereby the family agrees with traders about limits on trades or costs imposed on trading. Notified of these restrictions or costs, traders either refrain (or are stopped) from trading after some level of action, or pay once the trade has been made.

1. Restrictions on Number of Trades

49. A number of open-end fund families have noticed that trading has increased in recent years.[115] Many of these families have explicitly attributed this increase to stale price exploitation.[116] One *ex post* policy to address this increase is to place a limit on the number of trades over a certain timeframe. Investors might be limited to four trades per year, for example.[117] A variation on this policy is to forbid another trade in a particular fund for a period of time, ten days for example, following a trade in that fund.[118]

50. Restrictions on trades certainly hit their intended target – those intending to trade to take advantage of stale prices. But exchange restrictions potentially impose costs on all shareholders, regardless of their trading motive. Arguably, some traders might not be seeking to exploit stale prices, but have "legitimate" asset allocation or liquidity needs. Trade limits impose costs on "innocent" traders, and are thus an unwanted side effect.[119]

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[113] *See* Ogden & O'Hagan, *supra* note 81 (finding that there is a lack of uniformity among fund sponsors in using fair value pricing).

[114] *See* Greene & Hodges, *supra* note 4, at 17-19. There would be no reason why a fund family could not combine both *ex ante* and *ex post* approaches. *See id.*

[115] *See* Lucchetti, *supra* note 40, at C19 (noting that the most disturbing trend is the widespread trading in retirement (401k style) as well as taxable accounts).

[116] *See* Jeffrey Laderman, *Fast-Buck Traders Get the Heave-ho,* BUS. WK., Sept. 6, 1999, at 74. (noting that traders could also be engaging in a market timing or sector rotation strategy); *see also The Bizarre, the Peculiar, and the Excessive*, TIAA-CREF PARTICIPANT, Nov. 1999, at 2-3.

[117] *See* Chalmers et al., *supra* note 3, at 2218-20. (finding that approximately 40% of their sample of funds reported such a limit on trading in their prospectus).

[118] This restriction reduces the option value of trading relative to a straight restriction on the numbers of trades.

[119] An analogy to a treatment for cancer is appropriate here. The chemotherapy attacks healthy, as well as cancerous cells.

51. Regardless of the side effects, a number of fund families have attempted to thwart stale-price trading using exchange restrictions.[120] Most families limit exchanges to between four and eight per year.[121] Others try to address concerns with side effects by reserving the right to limit exchanges for "market timers."[122] Despite the stated policies, the extent to which the funds actually enforce such policies is unclear. There is only weak evidence that explicit policies described in the fund prospectus that restrict exchanges are related to the actual level of stale price trading. In one empirical study of 109 international funds, about 40% (50 funds) had some type of exchange restriction.[123] The level of dilution between funds that had and those that did not have trading restrictions was virtually identical.[124] If trading restrictions were effective, funds with such restrictions should exhibit lower dilution. These results suggest that trading restrictions alone do not reduce dilution significantly.

52. Restrictions could be ineffective for several reasons. First, funds might be lax in enforcing trading restrictions or lack the technology to monitor trading activity. Because large fund families typically have ten million accounts or more, monitoring for trading activity and/or enforcing any restrictions on such activity in each account could be expensive. Indeed, some funds state that they only monitor the trading in large accounts (over one million dollars, for example).[125] Focusing on large accounts should reduce monitoring expenses. But this approach does nothing to deter stale price trading by those with account values under the limit.

53. Second, most exchange restrictions apply only to retail fund customers. Shareholders who invest in a fund through company retirement programs are often subject only to the terms of the retirement plan, which typically call for unlimited exchange privileges.[126] Even if the contract does not allow unlimited

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[120] Letter from David Shunk, Teachers Insurance and Annuity Association College Retirement Equities Fund (TIAA-CREF) to fund shareholders (May 1, 2000) (on file with author) (announcing a policy to limit transfers to three per month (from the same account) starting on June 1, 2000) [hereinafter Letter from TIAA-CREF].

[121] *See* Chalmers et al., *supra* note 3, at 2219-20.

[122] *See* TEMPLETON FOREIGN FUND PROSPECTUS (Jan. 1, 2001), *available at* http://franklin-templeton.com (last visited Aug. 29, 2001). The prospectus states, "The Fund may restrict or refuse purchases or exchanges by Market Timers. You may be considered a Market Timer if you have (i) requested an exchange out of any of the Franklin Templeton funds within two weeks of an earlier exchange request out of any fund, or (ii) exchanged shares out of any of the Franklin Templeton funds more than twice within a rolling 90 day period, or (iii) otherwise seem to follow a market timing pattern that may adversely affect the Fund." *Id.* at 32.

[123] *See* Greene & Hodges, *supra* note 4 at 17-19.

[124] *See id.*

[125] *See id* at 18.

[126] Retirement plans are large business deals for funds, so terms that favor flexibility for plan participants are not surprising. Some retirement plan providers are resisting this. TIAA-CREF is a noteworthy example. *See* Letter from TIAA-CREF, *supra* note 120. Trading inside retirement plans is an especially valuable strategy since most of these plans are tax-deferred. Rather than paying short-term capital gains rates for profits, as would occur in taxable accounts, all gains are deferred until distributions are made from the retirement account.

exchanges, shareholders in retirement plans have brought suits claiming such a right.[127] Because substantial holdings of mutual funds are in retirement plans, a fund's restrictions on "retail" trading activity are not particularly effective.[128]

54. To address the ineffectiveness of restrictions due to lack of sufficient monitoring technology or enforcement activity, the fund could employ additional resources and become more diligent. Monitoring and enforcing trading restrictions will be an expensive undertaking, however, and the costs will be borne by all shareholders.[129] Likewise, in the case of retirement plans, funds could lobby plan sponsors to enact and enforce exchange restrictions, or opt out of retirement plans that fail to adhere to or enforce exchange restrictions, or renegotiate the terms of the plan contract. However, these courses of action are costly. Increased monitoring vigilance and technology requires increased outlays, whereas harsher terms with retirement plans might lead to lower revenue for the fund family.

55. Enforcement of trading restrictions appears even more difficult when considering the open-end fund industry, rather than an individual family, as the target for stale-price trading. A trader could enter one family, use his/her limited number of exchanges, and then move on to another family. Mutual fund supermarkets make this strategy particularly easy to implement. As intermediaries between investors and funds, supermarkets such as Schwab One Source and Fidelity FundsNetwork, are becoming very popular with investors.[130] However, because they tend to bundle investor orders, supermarkets provide individuals with a degree of anonymity that might make trading restrictions more difficult to enforce. Using supermarkets, traders simply jump from one family to another without even leaving their accounts.[131] Therefore, trading restrictions at the family level cannot be expected to totally thwart traders exploiting stale prices.[132] A coordinated

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[127] *See* Eastman Kodak v. Colonial Trust VII, No. 99-CV-6235 (W.D.N.Y. filed June 4, 1999). In this situation, the plan entered into an investment management agreement with a mutual fund. At formation, no redemption fees were payable, but the fund subsequently added a redemption fee provision. Alleging that the fund was a fiduciary under ERISA, the plan argued that the imposition was improper.

[128] *See Investment Company Institute*, 1998 Profile of Mutual Fund Shareholders 7, 13, 47 (1999), *available at* http://www.ici.org, calculating that 72% of all mutual fund shareholders own shares through their retirement plan; 50% of share purchases are made through the retirement plan; and about 50% of assets held in retirement accounts).

[129] *See id.* (arguing that these costs must be compared to the costs incurred by allowing stale price trading).

[130] *See* J. Hechinger, *Fidelity's Rivals Help It Draw "Supermarket Shoppers,"* WALL ST. J., May 26, 1999 (citing the fact that over thirteen percent of all mutual fund purchases are done through either Schwab One Source or Fidelity FundsNetwork).

[131] *See, e.g.,* PROSPECTUS: CHARLES SCHWAB – MUTUAL FUND ONE SOURCE (2001), *available at* http://www.schwab.com (last visited Aug. 28, 2001).

[132] Fund supermarkets play a key role in addressing stale price trading. For example, TD Waterhouse requires orders to be placed before 2:00 P.M. American Express Brokerage has transaction fees on some accounts and limits or prevents Internet exchanges on others. Schwab requires a customer to hold the position for 180 days or else pay a redemption fee. *See, e.g.,* PROSPECTUS: TD WATERHOUSE BROKERAGE (2001), *available at* http://www.waterhouse.com (last visited Aug. 28, 2001); PROSPECTUS: AMERICAN EXPRESS BROKERAGE (2001), *available at* http://www.americanexpress/finance/brokerage.asp (last visited Aug. 28, 2001); PROSPECTUS: CHARLES SCHWAB – MUTUAL FUND ONE SOURCE (2001), *supra* note 131. Since the fund families are the customers of supermarkets, they might be responding to customer demand.

industry level policy would have to be employed.[133]

56. Regardless of any policy on trading restrictions, such restrictions will not render the stale-price strategy useless. Trading restrictions simply make stale-price trading profitable less often. If a trader is limited to four exchanges per year, the trader might still find it profitable to trade the fund. Empirical research shows that trading only a few times per year can enhance returns to traders, with their profits coming at the expense of the non-trading shareholders.[134]

57. Enacting trading restrictions is not easy, either. TIAA-CREF recently adopted more stringent exchange policies after noticing an increase in trading. Beginning in October 1999, TIAA-CREF enacted rules that began to restrict shareholders in terms of the number of exchanges in and out of funds. A number of shareholders were quite unhappy with both the restrictions and how they were put in place. Under fire from fund participants about lack of notice and confusion in implementation of the restrictions, TIAA-CREF sent out a new policy letter in May 2000.[135] Effective June 2000, participants would be able to make up to three transfers from the same account in a calendar month.[136] Transfers in excess of this number would result in a suspension of electronic (telephone, Internet, and fax) trading privileges for six months.[137]

58. Ironically, the well-publicized change in policy might have had an unintended and undesirable side effect. By raising general investor awareness of the issue, and the profits from stale price trading strategies, the new restrictions and their accompanying attention might lead more traders to take advantage of the profitable opportunity. While each trader might make fewer trades than before the change, their greater number could cause the dilution effect to worsen.

2. Redemption Fees

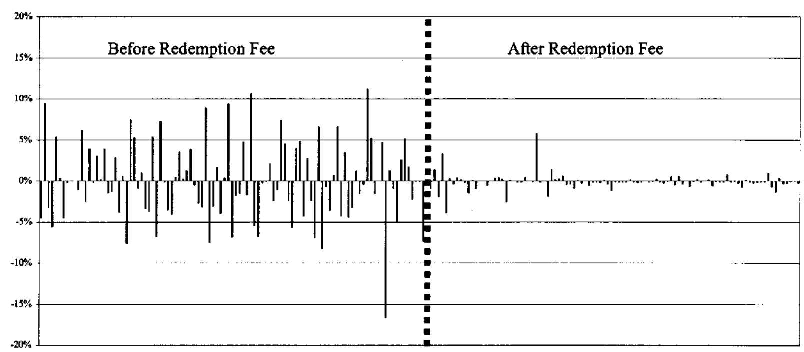
59. Another *ex post* policy measure that aims to thwart stale-price trading is the redemption fee.[138] Some fund families have initiated redemption fees for shareholders whose money has only been invested for a short period.[139] Typically,

[133] Fund families are in competition. Arguably any coordination of an industry-wide strategy would have to fall to industry-level associations (such as the Investment Company Institute) or to regulatory authorities.
[134] *See* Chalmers et al., *supra* note 3, at 2214-17.
[135] *See* Letter from TIAA-CREF, *supra* note 120.
[136] *See id.*
[137] *See id.*
[138] Unlike a load, which is akin to a commission, a redemption fee is returned to the fund itself. A front-end load is paid upon purchase, and might deter stale price trading for shares held only a short period of time since it imposes a trading cost that typically ranges between two and five percent. Back-end loads are imposed on sale, and should have a similar deterrent effect on stale price trading as redemption fees.
[139] *See, e.g.*, PROSPECTUS: INVESCO FUNDS (2001), *available at* http://www.invescofunds.com (last visited Aug. 28, 2001). On some funds, Invesco levies a one-percent redemption fee on shares sold within 90 days of purchase. *See also* PROSPECTUS: OAKMARK FUNDS (2001), *available at* http://www.oakmark.com (last visited Aug. 28, 2001). Oakmark charges a two-percent redemption fee for funds sold within 90 days of purchase.

these redemption fees are passed on to the remaining fund shareholders. Redemption fees are sometimes reduced or eliminated if the investor has held the shares for a particular length of time.[140] Redemption fees can be quite effective in reducing stale price trading. As an illustration, Exhibit 2 shows the impact of the inclusion of a two-percent redemption fee by the Invesco European Fund. This two-percent fee, which is imposed on any sale made within 180 days of purchase, results in a marked decrease in daily fund flows.[141] However, high redemption fees reduce the liquidity of *all* mutual fund flows and not solely those that represent stale price trading.

60. ***Exhibit 2 - Redemption Fee Impacts on Fund Cash Flows***

Daily Fund Flows (% of fund assets) for Invesco European Fund



61. This exhibit shows net daily fund flows to the Invesco European Fund for the months of January 1999 through September 1999. Effective May 1, 1999, Invesco levied a two percent redemption fee for exchanges out of the fund prior to a minimum 180 holding period. The average size of net daily fund flows falls from three and half percent before the fee to a half percent after the redemption fee is in place.[142]

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[140] *See* PROSPECTUS: CHARLES SCHWAB-MUTUAL FUND ONE SOURCE (2001), *supra* note 131. Schwab recently doubled (from 90 to 180 days) the time that retail customers in OneSource funds must hold an investment to avoid a redemption fee. Interestingly, institutional customers' holding period was extended as well, from 60 to 90 days.

[141] *See also* Chalmers et al., *supra* note 3, at 2216-2219 (finding evidence that funds at greater risk from stale price trading tend to use redemption fees).

[142] The daily fund flows data is provided by TrimTabs, Inc. of Santa Rosa, CA.

62. Similar to trading restrictions, redemption fees have unwanted side effects. Recent studies show that over half of the assets managed at the typical fund enter into and exit from that fund in the course of a year.[143] Redemption fees make capital less mobile, which has unwanted side effects such as sticking investors in the fund with a poor manager. As Exhibit 2 shows, daily flows in and out of the fund were markedly reduced. While some of these flows were likely to be stale price trading, others could have been "legitimate" movements by investors altering their asset allocation, or trades by those desiring liquidity.

63. Moreover, redemption fees cannot address the problems caused by large market moves. For example, in the 1997 Asian Crisis, a fourteen-percent overnight return was available based on the Hong Kong market. At that point, even a two-percent redemption fee would not deter stale price traders.[144]

64. So while redemption fees can curtail daily or very frequent trading, they will not eliminate dilution altogether. A redemption fee simply raises the threshold beyond which a stale price trader will execute an order. If the benefit to the trader exceeds the one-half percent redemption fee, for example, rational traders will choose to incur the cost of the redemption fee and exchange their fund shares. The fund is diluted by the difference between the benefit to the trader and the redemption fee. Moreover, if the fee is waived upon holding the shares for, say, ninety days, then the trader still gets approximately four round-trips per year at no fee. In either case, the fund purchases and sales continue to occur at stale prices.

IV. Regulatory Scheme

65. The public policy goals of the SEC rules regarding mutual fund pricing are to prevent significant dilution and speculative trading.[145] Despite these goals, the empirical evidence suggests that both dilution and speculative trading appear to occur with regularity.[146] This section examines whether the current regulatory approach to stale price trading, which relies on fair value pricing in response to "significant events," represents an effective policy. After reviewing the current regulatory scheme, the article proceeds to recommend two improvements. The first is based on the recognition that every day is a significant event when prices are stale. The second involves the consideration of techniques that do not involve pricing, namely *ex post* policies such as redemption fees, to address stale price trading. Lastly, the implications of these suggestions for the industry and for investors are discussed.

A. Fair Value (*Ex Ante*) Considerations

66. The duty of setting prices for open-end funds rests ultimately with the fund's

[143] *See* Edelen, *supra* note 11, at 447-48.
[144] Redemption fees, however, could provide deterrence for normal market fluctuation levels.
[145] *See* Barbash, *supra* note 70.
[146] *See* Greene & Hodges, *supra* note 4.

board of directors.[147] The board must conduct this function in good faith.[148] The SEC has brought actions against fund directors who have clearly failed to meet the good faith standard.[149] Examples include situations where the directors continued to fair value portfolio securities for an extended period of time even though they knew that those securities had either been de-listed or were restricted from sale.[150] In other cases, the Commission has found problems that relate more to pricing procedures (or lack thereof).[151]

67. The SEC has not hesitated to take enforcement action when there have been egregious violations of fund pricing rules. But what happens when funds attempt to use fair value pricing in good faith? Nearly twenty years ago, the SEC took "no action" in response to the use of fair value pricing by the Putnam Growth Fund.[152] From this decision, it appears that a good faith application of fair value pricing would pass SEC muster.

68. Despite the reluctance of the SEC to second-guess fund pricing done in good faith, the Commission has re-examined stale price regulations during the past three years.[153] Along with reminding directors of their good faith obligations, the SEC has suggested a number of operational procedures. Realizing that boards often delegate pricing matters to fund management, the Commission has recommended the creation of a valuation committee, the development of comprehensive valuation procedures, and periodic review of the valuation methods.[154] In addition, the Commission suggested that the fund board should evaluate the accuracy of their pricing methods by comparisons to quotations from pricing services and dealers, as well as the actual opening prices the next day.[155]

69. This article takes no issue with these recent communications by the SEC. As far as they go, the suggestions made are valuable to addressing stale price trading through the use of fair value pricing. Under current guidance, however, the use of fair value pricing is still tied to "significant events."[156] What constitutes a "significant event" remains very fuzzy. In the 2001 SEC letter, "significant event"

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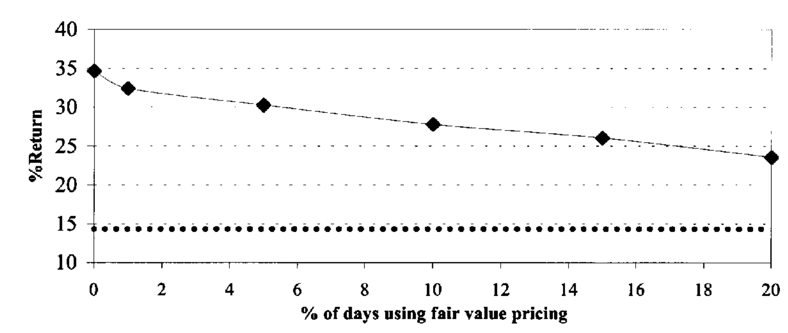
[147] *See* SEC Release, *supra* note 88; *see also* Pozen, *supra* note 56.
[148] *See id.*
[149] *See* SEC letter, *supra* note 97 (referring as examples to *Parnassus Investments*, where directors valued securities at the last NASDAQ quoted prices even after they knew the securities had been de-listed, and *Matter of the Rockies Fund, Inc., et al.*, where directors valued securities as if they were not restricted).
[150] *See id.*
[151] *See, e.g., In the Matter of William P. Hartl*, Exchange Act Release No. 33,165, 1993 SEC LEXIS 3063 (Nov. 8, 1993) (board failed to meet; failed to describe valuation procedures); *In the Matter of Brown*, Exchange Act Release No. 33,438, 1994 SEC LEXIS 30 (Jan. 6, 1994) (board failed to participate in valuation process); *In Mitchell Huggins Asset Management Inc.*, Exchange Act Release No. 39,001, 1997 SEC LEXIS 1793 (Sept. 2, 1997) (fund advisor failed to supervise a portfolio manager that unilaterally overrode pricing service and dealer quotes for mortgage backed securities).
[152] *See* Putnam Growth Fund, SEC No-Action Letter, 1981 SEC No-Act. LEXIS 3088 (Feb.23, 1981) [hereinafter Putnam].
[153] Extreme volatility in the Asian markets helped to bring attention back to the pricing issue.
[154] *See* SEC letter, *supra* note 91.
[155] *See* SEC letter, *supra* note 97.
[156] *See id.*

is defined, in a somewhat circuitous manner, as follows: "Whether a particular event is a significant event depends on whether the event will effect the value of a fund's portfolio securities."[157] Clearly, the emphasis is on large market moves, and for funds to use fair value when markets close for unusual events. But isn't the passage of 12-15 hours since the closing price has been determined, which happens every trading day even in the absence of a typhoon, government overthrow, or some other catastrophe, a "significant event"? Knowing the US market movement on the following day, even if it is quite ordinary, provides the stale price trader quite a bit of information. A typhoon is not required.

70. Exhibit 3 demonstrates that use of fair value pricing strictly in response to large market moves fails to remove the majority of profits from stale price trading. The sample includes 84 international funds that had an average annual return of 13.99% from January 4, 1993, through December 31, 1997. Initially, suppose that the funds in the sample do not employ any fair value pricing. The returns based on a stale price strategy of holding the international funds on days after an S&P 500 positive return and holding cash on days following a negative S&P 500 return average 34.65% a year. The profits from this stale price trading come at the expense of buy-and-hold investors.

71. ***Exhibit 3 - Fair Value Pricing and Returns from Stale Price Trading***



72. The results are based on a sample of 84 international funds during January 4, 1993 through December 31, 1997. The average annualized return (marked by the dotted line) for the fund portfolio is 13.99% over this period. The returns based on a stale price strategy of holding the international funds on days after an S&P 500 positive return and holding cash on days following a negative S&P 500 return results in an average annualized return of 34.65%, without fair value pricing of the mutual funds. The returns to the stale price strategy are reduced when fair value pricing is employed for the percentage of trading days indicated (from zero

[157] *See id.*

to 20 percent).

73. But what if the funds had employed fair value pricing techniques[158] on days with "significant" market moves? Fair value pricing on the one percent of trading days with the largest S&P 500 moves each year (i.e. two or three days per year) would reduce the stale price strategy return from 34.65% to 32.5% a year. Even employing fair value pricing on the 20% of trading days with the largest S&P 500 moves, or about once per week on average, would only reduce the stale price trading strategy return to about 23.5% a year.

74. Exhibit 3 shows that applying fair value pricing only on the most "significant" days lowers the profits to a market timing strategy that exploits stale prices. Still, implementing fair value pricing as frequently as once per week would leave substantial profits to a market timer, resulting in significant dilution. The current SEC guidance, however, is filled with references to pricing under "emergency or unusual situations."[159] It is difficult to reconcile "emergency" with once a week, or even once a month. As such, limiting the focus of fair value pricing to significant events narrows the scope too greatly, and misses a great deal of problem.

75. The SEC argues that "significant fluctuations in domestic or foreign markets may constitute a significant event."[160] But Exhibit 3 shows that significant dilution potential exists on days that do not have large market moves. Over a period of time, and with a large number of trades, the stale price strategy can expropriate a significant amount of wealth from buy-and-hold investors. The empirical evidence suggests that stale price traders have formed a systematic effort that is not tied only to big events but to daily trading, to bleed funds a little at a time.[161]

76. The SEC needs to communicate that fair value pricing might be a daily exercise. When prices are stale, as routinely occurs in international funds, prices are not "readily available" and every day is a significant event. As such, the term "significant event" really has no utility in this context. Its major purpose might be to dissuade funds from using fair value pricing because of uncertainty as to whether an event is significant.

77. The domestic situation provides another example. Under the current guidance for

[158] To simulate the effect of fair value pricing, it is assumed that funds use "perfect foresight." That is, on days that the fund decides to fair value its shares, it is assumed that the fund will realize the return it actually receives the following day. The following day's return is corrected (assuming no fair value pricing) by setting its return to zero. While extreme, this method of fair value pricing is unquestionably "fair." That is, it removes any predictability of the fund's following day's price. For robustness, we also implement a fair value scheme that uses the beta of a fund's returns regressed on the previous day's S&P 500 return to adjust the fund's return on fair value days. Beta is multiplied by the current day's S&P 500 return to achieve fair value vis-à-vis the current day's S&P 500. This process should remove the predictability of prices on these days. These results are nearly identical to those using perfect foresight.
[159] *See* SEC letter, *supra* note 91.
[160] *See* SEC letter, *supra* note 97.
[161] *See generally* Greene & Hodges, *supra* note 4.

domestic stocks, significant events would probably be linked to market closings or trading halts in individual stocks. But on the vast majority of days, stale price traders are free to exploit prices that might be several hours old, especially in the case of small capitalization stocks that are thinly traded. The empirical evidence suggests that the profit potential for stale price trading of small capitalization stocks is also very significant.[162]

B. Recognize that *ex post* techniques can address stale price trading

78. At this stage, the entire stale price regulatory scheme is based on *ex ante* (pricing) methods. Regulatory communications involving *ex post* techniques would improve the overall scheme. The Commission has not commented on *ex post* approaches to the stale price problem in its recent communications; rather, the focus is on fair value pricing in response to significant events.

79. When the SEC has discussed trading costs, such as redemption fees, it has generally been to express concern about their use.[163] In particular, fees above two percent have triggered a strong negative reaction.[164] Raising the costs for shareholders to leave a fund reduces the liquidity of mutual fund assets.[165] As a barrier to exit, redemption fees tie shareholders to poor managers or harm them if they change investment objectives and need to leave a particular fund.

80. Clearly the Commission wants to be careful about advocating increases in trading costs. That might explain the failure to discuss *ex post* policies as a tool to address stale price trading. But *ex post* policies can be quite an effective tool to combat stale price trading, as Exhibit 2 shows. In the case of Invesco European Fund, the imposition of a two-percent redemption fee for sales within 180 days of purchase virtually eliminates daily trading.

81. Similar to the disclosure of fair value pricing policies, the adequate disclosure of *ex post* approaches is necessary for investors to make informed decisions. Disclosure of *ex post* costs to shareholders up front provides investors with an opportunity for efficient selection of funds. For example, if a fund chooses to impose costs on short-term trades, then investors seeking to take advantage of stale prices might be deterred from entering the fund. Those investors with long-term objectives are unaffected by the added costs imposed on short-term trading.

82. Unlike the concerns about redemption fees, however, the SEC has apparently not

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[162] *See* Chalmers et al., *supra* note 3, at 2214-16.
[163] *See* Erin Arvedlund, *Some Mutual Funds Are Making It Dearer to Juggle Your Nest Egg*, BARRONS, May, 8, 2000, at 28 (quoting Cynthia Fornelli, senior advisor to the SEC Director of the Division of Investment Management, "Nobody has persuaded us yet that a redemption fee above two percent is justified.")
[164] *See id.*
[165] *See* Laderman, *supra* note 116, at 74 (arguing that exit fees can work against investors' interests by stopping some investors who would be better off selling the fund).

found any difficulty with limitations on the number of trades.[166] Similarly, other limits on trading frequency or timing would appear to be acceptable, especially if aimed at stale price trading. One example is a minimum holding period for exit from or re-entry to a fund following a purchase or sale, respectively. Such restrictions might be very effective against stale price trading since it reduces the trader's options for moving in or out of the fund.

C. How would these regulatory refinements affect industry operations?

83. This section discusses the impacts of the two suggested refinements to the existing regulatory policy on stale price trading. How would funds react to these suggested policy changes and what would be the impact on investors? Both the relaxation of "significant event" triggers and the sanctioned use of *ex post* approaches to combat stale price trading broaden the regulatory latitude offered by the SEC. Arguably, the policy changes make the choice to combat or ignore stale price trading clearer for funds. Assuming proper disclosure of *ex ante* and *ex post* approaches to investors, the article suggests that the refinements encourage a more efficient self-selection in the industry. Stale price traders can be with their own kind, while long-term shareholders can do the same. In sum, it is not trading itself that is undesirable, but the dilution that results from stale-price traders "cohabiting" with long-term shareholders. Making the distinction between funds that tolerate and those that discourage stale price trading is a positive step for both investors and the open-end fund industry.

1. Long-term shareholder interests

84. The regulatory invitation to combat stale price trading more broadly would be welcomed by families that are trying to protect the interests of long-term shareholders. While it is certainly possible that these families employ daily fair value pricing and *ex post* approaches already, a regulatory sanctioning of their appropriateness (given proper disclosure) would provide additional support against claims by traders that such techniques are not permitted.[167]

85. A stronger posture against stale price trading is only fair to long-term shareholders given the irony in the common admonitions of mutual fund sponsors to invest for the long-term. While this advice is technically correct, it is also misleading.[168] Those investors following long-term, buy-and-hold strategies see (or more likely *do not* see but nonetheless experience) a depletion of their wealth as stale price traders systematically raid open-end funds. The NAV produced by

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[166] *See* SEC Release, *supra* note 88.

[167] *See* Lucchetti, *supra* note 40 (discussing the rights of various groups who time the market); *See also* Ogden & O'Hagen, *supra* note 81 (describing the complaints filed after fund using fair value pricing in response to the Asian Crisis).

[168] *See McMahan & Co. v. Wherehouse Entertainment*, 900 F.2d 576 (2d Cir. 1990); *Lucia v. Prospect St. High Income Portfolio*, 36 F.3d 170, 176-77 (1st Cir. 1994) (discussing disclosures that are technically correct but potentially misleading).

the fund's manager makes this looting possible. Thus, while explicitly advising a buy-and-hold strategy, fund managers implicitly encourage the stale price trading that erodes the wealth of those following their explicit advice.

86. To this point, the SEC has only sanctioned open-end fund directors for egregious violations of pricing rules.[169] Funds appear to have little to fear in terms of regulatory sanctions in response to *good-faith* pricing efforts. However, open-end funds with long-term shareholder clienteles need to be aware of the discipline imposed by competition and market innovation. Failure to be willing and able to take action on stale-price wealth transfers might harm the salability of the open-end fund product. On the other hand, imposing daily fair value pricing and/or raising costs through fees and restrictions on trading might also reduce the salability of the open-end fund product. But long-term investors should value protection from raids more than they disfavor added trading costs.

87. The basic issue is how to protect owners of a financial product whose value is based on a periodically estimated NAV when active traders continually seek opportunities to arbitrage stale prices. Can product innovation render the open-end fund a dinosaur? Exchange traded funds (ETFs) are becoming a viable alternative for some investors. These securities appear to address open-end fund pricing weaknesses by offering shares that trade like individual stocks.[170] Long-term investors might view ETFs as a superior investment product, free from the dilution plaguing open-end funds.[171] Based on their structure, ETFs should offer less of a stale price target than open-end funds.[172] The loss of long-term shareholders would greatly damage the open-end fund industry.

88. Given the additional regulatory latitude suggested by this article, fund boards might feel as if they had more leeway to attack the stale pricing problem. If the goal is to reduce the amount of stale price trading to the greatest extent possible, then a combination of *ex ante* and *ex post* techniques is probably the most effective policy. Having both types of tools would address the stale price problem itself as well as its symptoms.

89. Based on concerns for liquidity, however, fund boards might be reluctant to impose *ex post* policies. In this event, *ex ante* policies can be quite effective against stale price traders. Even *ex post* techniques alone can be effective based on the evidence in Exhibit 2. In sum, sanctioning the broader use of fair value pricing and *ex post* techniques can better protect long-term shareholders.

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[169] *See* SEC letter, *supra* note 97.

[170] *See* Aaron Lucchetti, *Tradable Shares Bring Some Buzz to Mutuals*, WALL ST. J., June 5, 2000, at R1; Hank Ezell, *Mutual Alternatives*, ATL. J. & CONST., June 4, 2000, at G3; *see also* Karen Damato & Aaron Lucchetti, *Critics Worry about the Risk of Exchange-traded Funds*, WALL ST. J., July 7, 2000, at C1, (describing exchange-traded funds as essentially a hybrid vehicle that has features of both an open-end fund and a futures contract). Exchange traded funds have grown in assets from zero in 1993 to $45B in 2000. *Id.*

[171] *See* Jonathan Clements, *A Bettor's Mousetrap Gets Better*, WALL ST. J., May 30, 2000, at C1.

[172] *See generally* Chalmers et al., *supra* note 3. Stale price trading opportunities in ETFs are arguably less than those available in open-end funds since prices are continuously updated in the former.

2. Traders' Interests

90. Not all funds fight stale price trading with the same vigor. Even under the regulatory changes envisioned in this article, it is likely that some funds might continue a policy that essentially ignores stale price trading.[173] Catering to traders has been a boon to some families that are searching for a profitable niche in the increasingly crowded open-end fund universe.[174] Arguably, the current regulatory scheme does not *compel* funds to address stale price trading. The SEC's 2001 letter states that fair value pricing *should* occur after a "significant event."[175] But in the same letter, the SEC acknowledges that funds might use their own milestones or triggers, and recognizes that under the same circumstances it is entirely possible that one fund might use fair value pricing and another would not.[176] Extending that logic to *ex post* techniques, some funds might have a different view of the costs and benefits of redemption fees or trading limits, for example.

91. The SEC remains reluctant to 'cross the line" and enter a regulatory regime where they dictate pricing rules. This article's proposals refine the circumstances and scope of stale price trading policies but do not alter the approach whereby individual funds make their own decisions about fair value pricing and trading costs with reasonable diligence and procedures. The Commission correctly recognizes that disclosure to investors is critical to a "market oriented" regulatory approach to stale price trading.[177] Even if the SEC communicates that every day could be a "significant event" and that *ex post* approaches could be used to fight stale price trading, fund boards would still have the latitude to use fair value or impose trading restrictions/costs. Boards less sanguine about the benefits of fair value pricing might be more inclined to balance interests in such a way as to favor trading. Boards more concerned about maintaining liquidity might be less inclined to impose redemption fees or trading limits. Given these "pro-trading" policies and proper disclosure, informed long-term investors are free to go elsewhere.[178]

3. Protecting the uninformed

92. Where long-term investors can be hurt is by their inadequate recognition (or by insufficient disclosure) of a fund's inclination towards stale price trading. What does this article offer to those investors? The SEC is currently unwilling to write formal pricing rules, and this article does not suggest that they do. So uninformed

[173] *See* Charski, *supra* note 21 (commenting that several families, including ProFund Advisors LLC, Potomac, and Rydex, welcome high frequency traders).
[174] *See* Ken Brown, *Buy! Sell! Rydex Gives Fast Traders the Time of Day,* WALL ST. J., May 1, 2000, at M1.
[175] *See* SEC letter, *supra* note 97.
[176] *See id.*
[177] *See* SEC Release, *supra* note 88.
[178] *See* Chalmers et al., *supra* note 3, at 2223-24. The value of such a position would seem to turn on whether investors are adequately notified of the firm's practices.

investors remain at risk for dilution.[179]

93. Implementing this article's recommendations, however, would extend the boundaries of acceptable stale price policies and signal the mutual fund industry again about the seriousness of the issue. Short of dictating pricing rules, the SEC should continue to advise funds about the impacts of stale prices. Continued communication between the SEC and the industry will also increase the likelihood that funds adequately disclose the issue to investors.

V. Summary and Conclusions

94. Modern Internet and communications technology has made mutual fund trading quite easy. Given the structural flaws in mutual fund pricing, the technology has also put forward a challenge to current regulatory policy. This article examines the economic and regulatory policy issues surrounding stale price trading in open-end mutual funds. International funds are especially vulnerable to stale price trading because the prices they use to calculate their net asset value (NAV) are often 12 to 15 hours old. Small capitalization domestic funds that are thinly traded are also at risk. Using these stale prices, traders can use technology to trade on a daily basis. They buy just before NAV increases and sell just before decreases, thus increasing their return without an increase in risk. Buy-and-hold shareholders pay for this windfall, and suffer significant wealth dilution. Empirical estimates from a sample of international funds suggest that this wealth transfer amounts to over a quarter of a billion dollars a year.

95. The SEC has focused its regulatory efforts on the use of fair value pricing by funds in response to significant events. Fair value pricing is an *ex ante* approach that relies on an algorithm to correct the NAV to reflect information that has been revealed since the last trade in the assets that comprise the NAV. This correction occurs *before* any trading takes place. Under current policy, fair value pricing requires a "significant event" trigger; otherwise a fund must use the "readily available" price. "Significant event" is defined in a circular way, and leaves funds open to two possible errors. Funds could use fair value when prices are "readily available" or funds could fail to use fair value pricing when prices are not "readily available."

96. This article offers two policy-oriented suggestions based on empirical analysis. Empirical estimates suggest that a significant proportion of the profits from dilution occur on "ordinary" days. Since modern technology makes trading easy, dilution is a daily problem (opportunity) for shareholders (stale price traders), and not just an issue that arises after "significant" market moves. So while fair value pricing after a tsunami is a good idea, fair value pricing on sunny days is a good idea too. The SEC should communicate that stale prices themselves constitute a

[179] *See generally*, Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359 (1998) (arguing that individual investors might not be able to rely on market forces to protect themselves from adverse consequences).

significant event, and that for some funds, especially international or domestic small cap, fair value pricing might be necessary on a daily basis to thwart attempts by stale price traders to raid funds.

97. Second, this article argues that the SEC should communicate that *ex post* techniques can be an appropriate regulatory response to stale price trading. *Ex post* approaches would impose costs (such as redemption fees) on traders *after* the trade. Or, these policies would restrict the right to trade *after* a certain number of trades occurred within an account. The article shows that implementing an *ex post* approach, such as a redemption fee, greatly reduces stale price trading. But while these policies can deter stale price traders, they do not discriminate, and could be costly to any shareholder that wants to trade. At this point, the SEC has been concerned only about the reduction in liquidity for shareholders. The article argues that properly disclosed trading costs and restrictions support a balancing of interests among traders and long-term shareholders. This balance is especially appropriate to consider given the advancements in trading technology.

98. Beyond the regulatory issues, addressing the stale price issue is critical for fund families from a business perspective. Setting up long-term shareholders with advertising that extols the virtues of patience, while permitting the fund to be looted on a daily basis, is an unsustainable strategy over the long run. The suggested refinements proposed by this article increase the arsenal of those funds interested in combating stale price traders. But even under the proposed regulatory refinements, the mutual fund industry would face a situation where some funds aggressively defend themselves against stale price trading while other funds continue to be far less vigilant. Those with trading motives are thus free to select families friendly to their habit. But more importantly, long-term investors must make informed decisions to avoid being bled. They need to select families where their interests will be protected.

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The dilution impact of daily fund flows on open-end mutual funds ☆

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Abstract

We examine how mutual fund flows that are correlated with subsequent fund returns can have a dilution impact on the performance of open-end funds. Active trading of open-end funds has a meaningful economic impact on the returns of passive, nontrading shareholders, particularly in U.S.-based international funds. The overall sample of domestic equity funds shows no dilution impact, but we find an annualized negative impact of 0.48% in international funds (and nearly 1% for a subsample of funds whose daily flows are particularly large). The exchange and pricing policies of mutual funds can thus have important performance-related implications.
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1. Introduction

Many open-end mutual funds provide virtually free and unlimited liquidity to those who wish to buy or redeem fund shares. The fund itself must either engage in

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costly trade or alter its cash position in response to mutual fund traders' exchanges. In effect, the active mutual fund trader imposes costs on the fund, which are passed on to the fund's passive shareholders. This paper focuses on how fund flows cause a shift in the fund's cash balance, resulting in a *dilution impact*. Active mutual fund traders contribute cash that is pooled with the mutual fund's existing risky assets. Once "in" the fund, the trader receives the pooled risky return—the same as any fellow shareholders. A trader who can accurately predict the future returns to the fund's risky assets can then capture the price swings in these assets without incurring a cost. Such traders dilute short-lived positive returns (and concentrate negative returns) with cash. This dilution impact is most plausible from short-horizon (e.g., daily) cash flows, since long-horizon cash flows can be invested quickly enough in risky assets to capture long-horizon returns.[1]

This paper considers the empirical question of whether daily fund flows from *active* mutual fund traders result in a measurable dilution impact. Chalmers, Edelen, and Kadlec (2001) (hereafter CEK) argue that a "wildcard option" exists in a broad cross-section of domestic and international open-end mutual funds as a result of stale prices. These stale prices give rise to profitable trading strategies in which active traders can earn abnormal returns of 10–20% annually. Bhargava and Dubofsky (2001) and Goetzmann et al. (2001) show that successful trading or market timing is possible in three international mutual funds. We confirm this finding and show that abnormal returns result from a market timing strategy in a large sample of international mutual funds. Though these previous studies establish the potential existence of profitable trading strategies, our paper is the first to show whether traders appear to adopt such strategies and how their net fund flows impact mutual fund returns. We find that net fund flows in international mutual funds in particular are consistent with active traders who take advantage of stale prices. We show a significant negative dilution impact in these funds of nearly 0.50% on an annualized basis. For the funds in our sample (representing approximately 20% of the assets of all U.S.-based open-end funds) we estimate that the dilution impact has brought about a net wealth transfer from passive shareholders to active traders in international funds in excess of \$420 million over a 26-month period. In contrast, we find no dilution effect on average in domestic equity or bond funds. Our results suggest that the dilution impact from frequent fund flows involves material wealth and can have a significant effect on mutual fund returns.

Beyond the dilution impact, fund flows affect other direct and indirect costs of the mutual fund, such as processing fees, increased cash holdings, and transaction costs.

[1] The term *dilution* has been used by others to describe the issue examined herein. Specifically, Pozen (1998) presents a case in which dilution was a major factor during volatile global equity markets in October 1997. Discussing the same incident, Barry Barbash of the SEC refers to dilution in a speech in 1997. We note that the dilution effect examined here is different than the *tax*-dilution identified in Brown, Goetzmann et al. (2001). However, the sense in which fund flows from one party result in an impact on another party through the structure in which a fund is organized remains similar.

Edelen (1999) focuses on how some of the indirect costs from this liquidity role can affect the performance of mutual funds and the inferences made in studies of managers' selection and timing skills. Using monthly fund flows and semi-annual fund transactions data, his analysis shows that liquidity-motivated flows can have an economically significant impact on the return to the mutual fund's passive investors through increased expenses and trading costs. Like Edelen, we find that fund flows affect the pooled return to all fund shareholders. However, we focus on *daily* fund flows that we expect to be transient and to induce only short-lived changes in the fund's cash balance. Such flows might not cause mutual fund managers to incur transaction costs. However, these flows could impose a cost on the fund by diluting the fund's risky asset returns. In the face of large daily fund flows, the type of impact primary to Edelen's analysis might not be observed even though a measurable impact due to dilution exists.

Our analysis of daily fund flows reveals patterns that are often different from those found in studies of longer-term flows. For example, Gruber (1996) and Zheng (1999) show a "smart money" effect, wherein fund flows tend to find funds that have a higher likelihood of good future performance. We show that daily fund flows in international funds appear able to predict subsequent-day returns, while flows in domestic funds are unrelated to the following day's returns. Sirri and Tufano (1998) show that net new money into a fund is affected by past performance, load fees, and management expenses. We find that daily fund flows appear larger in front-end load funds than in no-load funds and are seemingly invariant to stated restrictions listed in the fund's prospectus.

Other recent studies examine how short-term fund flows are related to overall equity market returns. Goetzmann and Massa (1999) and Edelen and Warner (2001) find that daily fund flows into and out of domestic mutual funds are correlated with, and could even cause, movements in the underlying U.S. markets. These two studies suggest that the flows of money into and out of mutual funds can have a measurable impact on the overall market. In contrast to examining how they affect the market for the underlying assets, we show how short-lived flows impact individual mutual funds' returns. We also show that daily flows in U.S.-based international funds *are motivated by* predictable future returns rather than *cause* movements in international markets.

This paper proceeds as follows. We first establish that there is ex ante reason to expect fund flows that originate from profitable trading strategies. Section 2 describes a simple trading rule that results in a "market timing" success rate high enough to earn expected abnormal returns of 15–20% per year by trading international open-end mutual funds. We empirically demonstrate fund flow patterns consistent with this profitable trading rule in Section 3, but find no evidence that profitable trading occurs on average in domestic funds. We develop and estimate a measure of the dilution impact from mutual fund flows in Section 4. Section 5 concludes the paper and offers implications for future research.

2. Daily market timing in international mutual funds

2.1. A market timing rule

A large body of literature documents the interaction between the U.S. market and international markets.[2] These studies generally show a contagion effect, in which price movements in one market spill over into other markets. The strongest correlation appears to originate in U.S. market moves. For example, a late-afternoon (New York time) increase in the U.S. market creates expected increases in the Asian and European markets which are closed at the time of the U.S. move.

Most U.S.-based international mutual funds hold securities that trade outside the U.S., though many maintain some holdings of U.S.-traded ADRs. U.S. Securities and Exchange Commission (SEC) rules require mutual funds to value their portfolios at least daily.[3] As stated by SEC Division of Investment Management Director Barry Barbash, "A fund is generally required to price its portfolio using readily available market quotations." Most funds routinely use each security's last traded price in its home market. In rare cases in which market quotes are not readily available or market conditions are extreme, the "fund is permitted to value the securities at their fair value determined in good faith by, or under the direction of, the fund's board of directors".[4] The portfolio's underlying securities' quoted (closing) prices are stale as of late-afternoon New York time, since they can not reflect the systematic information revealed in U.S. trading. This pricing structure creates a lead–lag relation between daily returns on the U.S. market and international mutual funds. Since most open-end mutual funds allow traders to submit orders to buy or sell fund shares as late as 4:00 p.m. New York time, CEK's "mutual fund wildcard option" is frequently in-the-money for international open-end mutual funds. That is, a profitable trading strategy might exist that exploits the stale prices of international mutual funds. Copeland and Copeland (1998) show that some profit opportunity exists in trading foreign-market futures contracts based on this correlation.

Consider the market timing rule of following an S&P 500 signal as a proxy for the U.S. market return. If today's S&P 500 return is positive just prior to the market close (e.g., at 3:55 p.m. Eastern), hold an international mutual fund tomorrow. Hold cash tomorrow if today's S&P 500 return is negative. To demonstrate the profitability of this stale-price trading strategy, we use daily fund net asset value (NAV) data from January 1, 1993 through December 31, 1997. The sample consists of 84 funds for which we have NAV and Morningstar data for funds with prospectus objectives of "World Stock" or "Foreign Stock". We match these fund returns with

[2] See, for example, Becker et al. (1990); Connolly and Wang (1998); Craig et al. (1995); Eun and Shim (1989); Hamao et al. (1990); Karolyi and Stulz (1996); King and Wadhwani (1990), and Lin et al. (1994).

[3] See the Investment Company Act of 1940 Rule 2a-4 (definition of "current net asset value") and Rule 22c-1 (pricing of redeemable securities for distribution, redemption, and repurchase).

[4] These quotes are from a speech by Barry Barbash given on December 4, 1997 at the 1997 ICI Securities Law Procedures Conference.

daily close-to-close returns for the S&P 500. We ignore fund distributions (typically occurring only annually or semiannually) in our sample, which biases downward (by 1–4% annually) our return estimates.

Panel A of Table 1 reports a 13.3% average annual return to a buy-and-hold investor (ignoring distributions) across these international open-end mutual funds from 1993 through 1997, compared with the S&P 500's 18.4% return. For each fund, we calculate the return to a market timer using the daily timing strategy based on the S&P 500 signal. This averages slightly over 34% per year across the international funds. These results are consistent with the expected returns in CEK, Goetzmann et al. (2001), and Bhargava and Dubofsky (2001). We also calculate the success rate by determining the percentage of days that the market timer is correct (i.e., invested in the fund on up days and in cash on down days). Across these funds, the average success rate is 63%. A buy-and-hold investor in the market index has a success rate of about 52%, as this investor is correct on all "up" days and incorrect on all "down" days. Though the strategy requires daily decisions, a market timer using international funds spends an average of 2.12 days holding a position (cash or the fund). Panel B shows that the abnormal return (alpha) of the market timer is significantly positive. The market timing success rate of this strategy is substantially positive in a quadratic model specification. Consistent with the fact that the market timer spends nearly half the time holding a cash position, the market index exposure (beta risk) of the timing strategy is about half that of the buy-and-hold investor. These results are comparable to the simulation results in Greene and Hodges (2001) in which a market timer with a 65% success rate earns an expected return of 34.16% per year and beats the buy-and-hold investor in the market index nearly 98% of the years. Their results indicate that the time-series standard deviation of annual returns at this success rate is 12.34%. Overall, this trading strategy yields expected returns substantially higher than the market's with slightly lower risk.

2.3. *iShares versus international mutual funds*

We might expect the iShares to be better signals of the mispricing of international mutual fund shares compared with the S&P 500 since they potentially reflect up-to-the-minute values of international market baskets during U.S. trading hours. To examine this possibility, we construct an iShares signal for trading open-end funds in the following manner. We form region portfolios of iShares using weights based on (Morgan Stanley Capital International (MSCI)) market capitalizations. Using the Morningstar-reported portfolio composition weights by country or region (e.g., Japan, Europe, etc.), we obtain a signal for each fund. Though we do not claim to optimize the iShares signal, this procedure should conceptually yield a high-quality iShares signal since it takes into account portfolio-specific information. Panel C reports the trading strategy returns using either an iShares signal or the S&P 500 signal over the same sample period. The S&P 500 signal appears to yield a higher return. These results suggest that iShares prices might not be completely marked to

Table 1

Descriptive statistics for daily market timing strategies

Panel A shows the returns to buy-and-hold international mutual fund investors versus market timers following a trading rule of exchanging cash for international fund shares when the day's S&P 500 index return is positive and exchanging international fund shares for cash when the day's S&P 500 index return is negative. The panel also presents the cross-sectional distribution of the market timing success rate and the market timer's position length calculated as the number days holding a position in the risky or risk-free asset. Panel B presents performance measures for international fund buy-and-hold versus market timing investors using a market model (and a quadratic form to capture market timing ability). The sample includes 84 international mutual funds for which daily NAV data are available for the period January 2, 1993 through December 31, 1997. The market timer's rule of switching from the risk-free asset to an international mutual fund based the daily return of the S&P 500 index required 595 trades.

Panel C shows the returns to buy-and-hold iShares (formerly known as WEBS) investors versus market timers following the S&P 500 trading rule. Panel D reports international fund market timing returns using a trading signal based on eithger the S&P 500 return or the iShares return. The sample includes 16 iShares securities and 84 international mutual funds for which daily price quotes are available for the period April 1, 1996 through December 31, 1997.

Panel A: Mutual fund stale-price trading strategy, using S&P 500 signal

	Buy-and-hold fund returns	Market timing strategy returns	Market timing success rate	Strategy position length
Mean	13.33%	34.24%	0.6333	2.12
Std. dev.	3.80	4.24	0.0139	1.43
Maximum	23.10	43.58	0.6609	12.00
75%	15.49	37.56	0.6410	3.00
Median	13.22	34.00	0.6359	2.00
25%	11.14	31.02	0.6260	1.00
Minimum	4.60	25.33	0.5911	1.00
N	84	84	84	595

Panel B: Average regression parameter estimates (t-statistics) using daily returns (N = 84)

Dependent variable	Intercept	R_M	R_M^2	R^2
Buy-and-hold	0.0003*	0.7040**	—	0.6251
fund returns	(1.92)	(36.63)		
	0.0004**	0.7014**	−3.5662**	0.6302
	(2.85)	(36.69)	(−2.80)	
Market timing	0.0013**	0.3282**	—	0.3110
strategy returns	(9.60)	(16.99)		
	0.0007**	0.3364**	11.32**	0.4123
	(5.65)	(19.17)	(10.65)	

Panel C: International mutual fund market timing, using S&P 500 Versus iShares trading signal

	Using S&P 500 signal		Using iShares signal	
	Trading strategy returns	Trading success rate	Trading strategy returns	Trading success rate
Mean	41.26%	0.6576	29.65%	0.6143
Std. dev.	7.00	0.0173	7.82	0.0294
Maximum	61.18	0.6982	56.14	0.6892
75%	45.82	0.6689	34.55	0.6329
Median	41.80	0.6577	27.09	0.6149
25%	36.44	0.6475	24.93	0.5901
Minimum	22.77	0.6126	10.93	0.5428
N	84	84	84	84

*Significant difference from zero at the 5% level.

**Significant difference from zero at the 1% level.

market vis-à-vis the U.S. markets, perhaps due to the relatively infrequent trading of these instruments.[5]

In summary, stale prices in open-end international mutual funds give rise to a market timing trading strategy using the S&P 500 return as a signal. To the extent that this strategy is feasible and can be followed nearly costlessly, traders would find this strategy profitable. We examine below whether traders do follow this strategy and, if so, what impact their trades have on passive shareholders in these funds.

3. Daily mutual fund flows

3.1. Sample description

TrimTabs, Inc. provided mutual fund data for a period beginning February 2, 1998 and ending March 31, 2000. A description of TrimTabs, Inc. can be found in Edelen and Warner (2001), who associate daily aggregate mutual fund flows with overall market returns. We have daily observations of per share net asset value (p_t), total net assets (a_t), and a distribution indicator for all funds covered by TrimTabs, Inc. We put the data through rigorous screens for errors. Since the focus in this paper centers on the interaction of returns and fund flows, we want to minimize the potential for errors in the total assets, fund flows, and NAV series. We search for extreme observations in each series. When the NAV appears to be the source of the extreme observation, the NAV is hand-checked against alternative sources. Those that can be corrected and verified are kept, while remaining suspicious observations, such as apparent keying errors, are discarded. In total, less than 0.30% of our sample observations are discarded.

We match the TrimTabs data with fund description data from Morningstar, including the prospectus objective of each fund. From the prospectus objective, we categorize funds to fit four style categories: bond, growth, stock, and international. We intend these style categories to proxy for the potential profitability of stale-price trading strategies as described by CEK, where profits might be expected in international and growth categories more so than in stock and bond categories. Any fund listing a bond objective is classified as a bond fund. Any fund with an objective of emerging markets, Europe, foreign, Pacific, or world stock is classified as an international fund. Domestic growth and aggressive growth funds are classified as growth funds, while the remaining domestic equity funds are classified as stock funds. The weightings across prospectus objectives between our sample and the Morningstar universe are quite similar. Across all categories, our sample funds represent approximately 20% (in number and asset size) of the universe of U.S.-

[5] In examining trading volume for iShares (not reported in the tables), we find slightly higher afternoon trading volume on S&P 500 signal days than on other days. We find these results interesting but puzzling since it is difficult to discern whether the increased trading could be profit-motivated from a stale-price iShares strategy or hedging-motivated from arbitrage strategies using iShares to hedge the purchases of open-end mutual funds.

based mutual funds. We have conducted our analysis with alternative classifications of these objectives with no meaningful change in our results. We exclude 47 funds in eight "specialty" categories and 12 funds in the "asset allocation" category, as they do not readily fit into any of our other groups, have little in common, and represent a small subset of assets.

Funds for which we do not have at least 100 days of data or do not have matching Morningstar data are discarded. We also remove funds that average less than $10 million per day in net assets. This results in a sample of 433,670 daily observations from 833 mutual funds. Counted among these 833 "funds" are multiple classes of the same fund (e.g., Class A or B shares). Since there is no a priori reason to assume that the flow to one class would be the same as that to another class of the same fund, we do not aggregate classes into one fund. For example, the distinguishing feature of one class versus the other of the same fund can be a front-end load or exchange privilege. This could influence the daily flow characteristics across different classes of the same fund. We have conducted our analysis using funds aggregated across classes and find no meaningful difference in the results.

Table 2 reports descriptive statistics for our sample of funds. The average (median) size of the funds in our sample is $954 million ($402 million). Growth funds are significantly larger than the other fund types, with an average (median) of about $1.7 billion ($648 million) in net assets. Domestic stock and bond funds have average (median) net assets of $973 million ($552 million) and $539 million ($303 million), respectively. International funds have average (median) net assets of $688 million ($163 million). Since a few funds enter our sample after the start of our sample period and some exit before the end of our sample period, we annualize each fund's return, assuming daily compounding, for comparability. The average stock fund over the 26-month period has a 14.97% annualized return compared with a 20.5% annualized return for the S&P 500 index over the same period. Bond and growth funds have average annualized returns of –2.51% and 33.70%, respectively, while international funds average a 26.44% annualized return.

3.2. *Daily fund flows*

From the changes in NAV and total net assets, TrimTabs computes a mutual fund's net fund flow (purchases less sales of fund shares) on date t as

$$c_t = a_t - a_{t-1}\frac{p_t}{p_{t-1}}. \tag{1}$$

This calculation accurately yields date t fund flows as long as the total net asset numbers are *post-flow* (i.e., they reflect date t flow). We compare TrimTabs data with GAAP-conforming balance sheets filed with the SEC, since GAAP requires total net assets to be reported *post-flow*. In most cases, TrimTabs receives *pre-flow* daily net asset numbers from the mutual fund companies (i.e., they do not account for the current day's flow). In these cases, flow attributed to date t actually occurs on date $t-1$. Appendix A discusses more thoroughly the methodology we employ to determine whether flow for a particular fund is timely or is lagged by one day. For

Table 2
Cross-sectional distribution of total assets and annualized returns
Cross-sectional distribution of average daily total assets of each sample mutual fund from February 2, 1998 through March 31, 2000. The sample includes 833 mutual funds followed by TrimTabs, Inc. whose objective is categorized as bond fund, growth fund, stock fund, or international fund. Assets are reported in millions of dollars.

	Full sample	Bond	Growth	Stock	International
Panel A: Average daily assets					
Mean	954.09	538.89	1,705.57	973.13	687.81
Std. dev.	2,147.29	696.80	3,660.76	1,232.07	2,088.74
Median	402.38	303.24	648.71	552.48	162.65
Category Assets	788,187	156,589	356,459	206,583	68,556
Category Funds (N)	833	309	204	211	109
Panel B: Annualized returns					
Mean	14.57%*	−2.51%*	33.70%*	14.97%*	26.44%*
Std. dev.	24.37%	7.79%	29.97%	17.52%	21.19%
Median	7.24%	−3.02%	30.23%	11.44%	23.59%
N	833	309	204	211	109
%Positive	61.7%**	4.7%**	95.1%**	83.4%**	97.2%**

*Significant difference from zero at the 1% level.
**Significant difference from 50% at the 1% level.

those funds that we infer report flow with a lag, we adjust the date on the flow by one day. This adjustment is at the heart of the conflict between our results and those of Goetzmann et al. (2001). Also, an adjustment should be made for distributions, such as dividends, income, or capital gains. However, TrimTabs advises that mutual funds do not handle distributions in a uniform manner. Therefore, we discard any observations on distribution dates, mostly occurring in December. TrimTabs suggests using caution with December data due to the high frequency of distributions in this month and the possible resulting errors. We have checked our results by removing December data from the sample with no meaningful change.

Fund flow statistics appear in Table 3. Panel A reports the cross-sectional distribution of average daily flow as a percentage of the fund's assets. Both stock and international funds have a daily net flow statistically reliably different from zero at −0.02%, which implies an annual flow of approximately −5%. In Panel B, we report the average daily flow magnitude, which gives an indication of the daily net trading activity of mutual fund shares. The magnitude of daily net fund flows averages 0.43% of fund assets across all sample funds. Bond funds experience the lowest average amount of fund exchanges at 0.31% of assets. Stock and growth funds have daily fund flows of 0.34% and 0.45%, respectively. The magnitude of fund flows is significantly higher across international funds, averaging 0.91% of assets. With 250 trading days per year, this implies that the average international fund experiences an

Table 3

Average daily percentage fund flows

Cross-sectional distribution of daily fund flows for a sample of open-end mutual funds from February 2, 1998 through March 31, 2000. The sample includes mutual funds followed by TrimTabs, Inc. whose objective is categorized as a bond fund, growth stock fund, international fund, or stock fund. Fund flows are expressed as a percentage of fund assets. Panel A reflects average daily fund flows, where daily net outflows are negative and daily net inflows are positive. Panel B reflects only the magnitude (i.e., absolute value) of daily fund flows.

	Full sample	Bond	Growth	Stock	International
Panel A: Average daily fund flows					
Mean	−0.01%	−0.01%	0.01%	−0.02%*	−0.02%**
Std. dev.	0.11%	0.08%	0.13%	0.13%	0.10%
75%	0.04%	0.03%	0.06%	0.04%	0.03%
Median	−0.01%	−0.01%	−0.01%	−0.02%	−0.02%
25%	−0.06%	−0.05%	−0.04%	−0.08%	−0.07%
N	833	309	204	211	109
%Positive	42.3%***	42.1%	47.5%	39.3%****	38.5%****
Panel B: Average absolute value of daily net fund flows					
Mean	0.43%	0.31%	0.45%	0.34%	0.91%
Std. dev.	0.57%	0.28%	0.71%	0.30%	0.91%
75%	0.48%	0.38%	0.50%	0.37%	1.20%
Median	0.28%	0.24%	0.32%	0.26%	0.56%
25%	0.18%	0.16%	0.20%	0.17%	0.33%
N	833	309	204	211	109

Difference-in-means test t-statistic		Growth	Stock	International
	Bond	2.67**	0.89	6.79**
	Growth		−2.16*	4.58**
	Stock			6.45**

*Significant difference from zero at the 5% level.
**Significant difference from zero at the 1% level.
***Significant difference from 50% at the 5% level.
****Significant difference from 50% at the 1% level.

annual turnover of about 225% of its assets, compared with an average of less than 100% for the other equity fund categories.

Large or frequent net fund flows could be consistent with large numbers of either liquidity traders with correlated demands or active market timers. Therefore, we examine further evidence to determine if the large flows in international funds, in particular, appear to be the result of successful market timers. First, we establish that the funds in our sample would be good candidates for the stale-price market timing strategy using international funds. Panel A of Table 4 shows the average correlation between the S&P 500 return and the following day's mutual fund return for our sample. International funds have a significantly higher average correlation of 0.3492 compared with 0.1000 across all other categories.

To be successful, the daily order flow for a mutual fund must, on average, result in profits to the traders as evidenced by daily net fund flows that predict the following

Table 4

Correlations among key variables

Cross-sectional distribution of correlations among key variables for a sample of open-end mutual funds from February 2, 1998 through March 31, 2000. The sample includes mutual funds followed by TrimTabs, Inc. whose objective is categorized as a bond fund, growth stock fund, international fund, or stock fund.

Panel A: Fund returns on day $t+1$ with the S&P 500 return on day t

	Full sample	Bond	Growth	Stock	International
Mean	0.1141**	0.0882**	0.0885**	0.0553**	0.3492**
Std dev.	0.1256	0.0940	0.0712	0.0854	0.0836
%Positive	85.7%***	86.3%****	90.7%****	68.2%****	100.0%****
N	833	309	204	211	109
Difference-in-means test t-statistic			Growth	Stock	International
		Bond	0.04	−4.15**	27.10**
		Growth		4.31**	27.64**
		Stock			29.59**

Panel B: Direction of fund flows on day t with the direction of fund return on day $t+1$

	Full sample	Bond	Growth	Stock	International
Mean	0.0192**	0.0150**	0.0106	0.0080	0.0689**
Std. Dev.	0.0824	0.0986	0.0608	0.0636	0.0830
%Positive	62.8%***	60.8%***	59.3%***	57.3%	85.3%****
N	833	309	204	211	109
Difference-in-means test t-statistic			Growth	Stock	International
		Bond	−0.62	−0.99	5.54**
		Growth		0.43	6.46**
		Stock			7.29**

Panel C: Signed fund flows on day t with the fund return on day $t+1$

	Full Sample	Bond	Growth	Stock	International
Mean	−0.0048	−0.0105	−0.0160*	−0.0148**	0.0512**
Std. Dev.	0.1056	0.1199	0.1015	0.0778	0.1009
%Positive	49.5%	49.2%	44.6%	43.6%***	70.6%****
N	833	309	204	211	109
Difference-in-means t-statistic			Growth	Stock	International
		Bond	0.55	−0.49	5.22**
		Growth		−0.13	5.60**
		Stock			5.97**

Panel D: Signed fund flows on day t with the S&P 500 return on day t

	Full sample	Bond	Growth	Stock	International
Mean	0.0577**	−0.0146**	0.1193**	0.0446**	0.1729**
Std. dev.	0.1435	0.0871	0.1503	0.1061	0.1920
%Positive	64.8%****	45.3%***	83.3%****	66.4%****	82.6%****
N	833	309	204	211	109
Difference-in-means test t-statistic			Growth	Stock	International
		Bond	11.51**	6.71**	9.85**
		Growth		−5.83**	2.53*
		Stock			6.48**

*Significant difference from zero at the 5% level.

**Significant difference from zero at the 1% level.

***Significant difference from 50% at the 5% level.

****Significant difference from 50% at the 1% level.

day's fund return. We examine this in two ways. First, we consider whether the direction of a mutual fund's flow is correlated with the direction of the next day's fund return. If net fund flow is positive, we assign the flow direction variable the value one. If flow is negative, we assign a zero to the flow direction variable. We classify the direction of the following day's return similarly. Panel B of Table 4 reports the correlation between the direction of net fund flows with the direction of the following day's fund return to be a statistically significant 0.0689 for international funds and 0.0150 for bond funds. This correlation is slightly positive but statistically indistinguishable from zero for the other fund styles.

Second, we examine the correlation between daily percentage fund flows and the following day's fund return. It could be that successful trading is more pronounced on days prior to larger moves in prices. We expect this if some traders find it costly to trade or are restricted to trading only infrequently, as suggested in Bhargava et al. (1998). Panel C of Table 4 shows that the cross-sectional average of this correlation is negative for all fund styles except for international funds, which average a correlation of 0.0512 (significant at the 0.01 level). These results suggest that daily fund flows in international funds exhibit good market timing ability. The negative correlations in domestic funds are consistent with the results in Edelen and Warner (2001), where aggregate fund flows exert price pressure on the day they occur followed by price reversals the next day.

The correlations reveal the ex post profitability of daily fund flows in international mutual funds. However, we still must establish that the fund flows are ex ante profitable to argue that the flows are the result of rational traders following a market timing strategy. As noted earlier, we do not claim to be detecting the optimal timing strategy with respect to international funds. We are simply seeking evidence of fund flows that are consistent with what historical data suggest to be a profitable trading rule. If flows in international funds follow daily market timing signals from movements in the U.S. market, we should find a high correlation between international fund flows and the S&P 500 index return. Panel D of Table 4 shows that international fund flows have a correlation of 0.1729 with the same day's S&P 500 return. Growth and stock funds have a correlation of 0.1193 and 0.0446 (both significant), respectively. These correlations are consistent with Edelen and Warner (2001) and Goetzmann and Massa (1999), who find evidence that domestic equity fund flows are associated with concurrent movements in the U.S. market. Bond funds have a significant negative correlation of 0.0146. The international fund flow's correlation is significantly higher than any other style's correlation. Of the international funds, 83% have a positive correlation between fund flows and the same day's S&P 500 return.

Overall, these results differ markedly from those reported in Goetzmann et al. (2001), who also examine the stale-price market timing rule and offer policy solutions. They find little evidence of a correlation between international fund flows and subsequent international fund returns and conclude that traders do not appear to exploit this simple, feasible, and profitable trading rule. Though their sample originates from the same source as ours, they do not make the adjustment to properly align fund flows in time. Appendix A argues why we maintain the accuracy

of our results against theirs. Moreover, anecdotal evidence from the popular press and the mutual funds themselves suggest that the mutual fund industry observes the same patterns in the data that we estimate in our sample. Fidelity Funds claims to dedicate significant resources to detecting and restricting accounts engaged in active trading of international funds (*New York Times*, April 9, 2000, Section 3, p. 17).

3.3. International fund flows, trading strategies, and international fund returns

The evidence we have presented thus far is consistent with two explanations: (1) U.S.-based international mutual fund flows cause movements in the underlying markets; or (2) international mutual fund flows exploit the correlation between the U.S. and international markets by trading stale-priced mutual funds. Though we believe no direct methodology exists for disentangling these two explanations, this section reports evidence consistent with the latter explanation by examining fund flows and their relation to trading signals, liquidity shocks, and market moves.

We estimate whether international fund flows appear motivated by the S&P 500 trading signal by including the signal as an independent variable in a regression of international fund flows. We assign the "trading signal" variable, $signal_t$, a value of "+1" (move into international funds) when the S&P 500 return is positive on a day that follows a negative return. The signal is "−1" (move out of international funds) when the S&P 500 return is negative on a day that follows a positive return. On days when the S&P 500 return has the same sign as the previous day, the signal is "0" (no trade). Since the flows on day t, f_t, are measured in terms of the proportion of fund assets, the coefficient on the trading signal variable is an estimate of the proportion of international fund dollars that follow this signal. If international fund flows are liquidity motivated and uncorrelated with this signal, then we will fail to find significance of this variable. We also include fund flows into domestic stock funds, $USFlow_t$, in the regression as an instrument to control for systematic liquidity shocks and possible momentum investing by U.S. investors. We estimate the international fund flows model,

$$f_t = \beta_0 + \beta_1 signal_t + \beta_2 USFlow_t + \eta_t. \tag{2}$$

The regression results in Table 5 indicate that approximately 0.40% of the assets per day in international mutual funds follow the S&P 500 "trading signal." The coefficient on the trading signal remains significant and close to the same point estimate after controlling for the significant effect of aggregate flows into U.S. equity mutual funds. We have performed this analysis using alternative models of international fund flows, including models that control for the magnitude of S&P 500 returns and others using U.S. fund flows that are orthogonal to S&P 500 returns. We have also performed the analysis on a disaggregated basis, using individual international mutual fund flows. In all cases, the results remain qualitatively the same. As an additional check, we perform the same analysis using domestic stock fund flows. In this case, the coefficient on the trading signal variable is insignificant when considered alone and significantly negative when considered in the model with the S&P 500 returns.

Table 5
International fund flows and trading signals
This table reports parameter estimates (with t-statistics in parentheses) of the proportion of assets, as measured in daily aggregate international fund flows, f_t, that follow a trading signal, $signal_t$, based on the direction of day t returns on the S&P 500 index. To proxy for liquidity or momentum-based flows, we also include the aggregate flows to U.S. stock funds, $USFlow_t$. We estimate alternate forms of the regression model
$f_t = \beta_0 + \beta_1 signal_t + \beta_2 USFlow_t + \eta_t$.

	β_0	β_1	β_2	N	R^2
Without U.S. stock fund flows	−0.0001	0.0044**		534	0.233
	(−0.66)	(12.72)			
With U.S. stock fund flows	0.0003	0.0041**	2.0305**	534	0.385
	(0.98)	(13.31)	(11.57)		

**Significant difference from zero at the 1% level.

Our results indicate that a significant proportion (approximately 45%) of international fund flows are consistent with profit-seeking traders. However, we have not ruled out the possibility that these traders' flows are self-fulfilling prophecies. That is, fund flows in international funds could be causing the subsequent returns to the fund's assets that trade in the international markets. To distinguish between these two alternative explanations, we estimate a simple model of international fund returns.

Let r_{t+1} denote international mutual fund returns on day $t+1$ and S_t be the day t return on the S&P 500 index. Taking $\bar{F}_t$ as the day t average percentage international mutual fund flow that is orthogonal to the day t S&P 500 return, we estimate the model

$$r_{t+1} = \lambda_0 + \lambda_1 S_t + \lambda_2 \bar{F}_t + \varepsilon_t. \tag{3}$$

If fund flows into international funds today cause positive returns in the international markets (i.e., the international funds) tomorrow, then the coefficient on the orthogonalized flow should be significant. Alternatively, if the returns in today's U.S. market are the primary driving force behind tomorrow's international markets (funds), then only the coefficient on the S&P 500 returns will be significant. The regression results in Table 6 indicate no significance on the orthogonalized international fund flows, consistent with the conclusion that fund flows add no information to or influence on the following day's international market moves beyond that contained in the S&P 500 returns. As a robustness check, we also conduct the Davidson and MacKinnon (1981) J test to distinguish between the two competing hypotheses of international market returns. We find that U.S. market returns alone account for movements in international fund returns.

In summary, we find evidence of large daily net fund flows that are correlated with the subsequent day's mutual fund returns only for international funds. These flows are consistent with the behavior of active mutual fund traders who take advantage of stale prices in international mutual funds. The evidence is inconsistent with

Table 6
International mutual fund returns
This table reports coefficient estimates (with t-statistics in parentheses) of two alternative explanations of daily international mutual fund returns, r_{t+1}. The estimated model is

$$r_{t+1} = \lambda_0 + \lambda_1 S_t + \lambda_2 \bar{F}_t + \varepsilon_t,$$

where $\bar{F}_t$ is the day t average percentage international mutual fund flow that is orthogonal to the day t S&P 500 return, S_t. Under the explanation that U.S. market moves lead to international market returns, the parameter estimate on the S&P 500 return should be significant. Alternatively, if flows of money into international funds cause the international market returns, then the parameter estimate on the fund flows should be significant.

λ_0	λ_1	λ_2	N	R^2
0.0003	0.3089**	0.0034	534	0.164
(0.59)	(6.28)	(0.03)		

**Significant difference from zero at the 1% level.

alternative explanations that international fund flows are liquidity-motivated or that these flows give rise to international market returns.

4. The dilution impact of daily fund flows

This section develops a methodology to measure the impact of daily fund flows on mutual funds' NAV returns. Specifically, we motivate a measure of the dilution impact which results from short-lived shifts in a fund's cash position that dilute the returns to the fund's risky assets.

4.1. Estimating dilution from daily fund flows

Consider an open-end mutual fund with assets of a_{t-1} at the beginning of this period (i.e., the end of last period). Suppose that over the next period these assets generate a rate of return of r_t. If there are no flows of cash into or out of the fund, then the return on the fund's NAV over the next period is

$$r_t = \frac{a_t}{a_{t-1}} - 1 = \frac{a_{t-1}(1 + r_t)}{a_{t-1}} - 1. \tag{4}$$

Now consider a fund flow of c_{t-1} that is marked to the fund's account at the end of last period. If we assume that the fund manager does not invest the cash in risky assets for at least one period, then the mutual fund's NAV return in the presence of cash flows is

$$\hat{r}_t = \frac{a_{t-1}(1 + r_t) + c_{t-1}}{a_{t-1} + c_{t-1}} - 1. \tag{5}$$

This is simply the return to the fund's assets in place prior to the fund flow, averaged with the zero return on the new cash. Since the shares represented by the new cash

share in the return from the assets in place, we must use the new cash in the denominator. This new cash eventually is invested to capture the risky assets' returns. Under the assumption that cash is invested costlessly after a one-period lag, no further consideration of the interaction of returns and time $t-1$ cash flow is required.[6] We calculate the impact of the $t-1$ fund flows on the fund's time t return to be the difference between the with-flow and the without-flow returns. Subtracting Eq. (5) from Eq. (4), the dilution impact is

$$\delta_{t-1} = \hat{r}_t - r_t = -1\frac{c_{t-1}}{a_{t-1}}\hat{r}_t. \quad (6)$$

The impact of fund flows is the negative of the (signed) percentage fund flow multiplied by the following period's realized fund return. Simply put, this measures the extent to which the return to the assets in place is diluted by new cash. Note that the dilution effect is related to the covariance of fund flows with subsequent periods' returns. Indeed, if either the expected flow or the expected return is zero, then the dilution effect is simply the negative of the covariance of the two. Therefore, the dilution effect could be positive or negative, primarily depending on the sign of the covariance. Cash flows that exhibit good market timing would have a positive covariance with subsequent returns, hence a negative impact from the dilution of positive returns. Conversely, flows that exhibit bad market timing would have a negative covariance and a positive impact on a fund's reported returns.

The dilution effect could be zero if the fund manager could trade the fund's underlying assets at the prices used when calculating the fund's NAV. Edelen and Warner (2001) report that fund managers typically do not receive a report of the day's fund flows until mid-morning the next trading day, which would make a zero lag unlikely. Since it is virtually impossible for international fund managers to trade their funds' underlying assets at the same values used in calculating their funds' NAV, it is reasonable to assume that international fund managers react to fund flows with at least a one-day lag.

Throughout this discussion we have focused on market timers making *daily* decisions. This need not be the case for us to focus on daily fund flows. That is, multiple traders could be following longer-horizon strategies that result in relatively infrequent trading. However, if their trading strategies have idiosyncratic components, then the fund manager observes daily net fund flows that are indistinguishable from those of a single trader following a *daily* strategy.

For each fund in our sample, we calculate the daily dilution impact of fund flows given by Eq. (6). We then calculate dilution's total impact on each fund by compounding the daily dilution impact over the 26-month sample period. To express the impact more transparently than reporting a 26-month impact, we calculate the *annualized* impact for a fund by scaling its total impact based on a 250-trading-day year. If fund flows are uncorrelated with the fund's next-day return, we expect the average impact to be zero. We conduct this two-sided hypothesis test with each style

[6] We have derived the dilution impact when cash is invested after multiple-day lags. We estimate this impact for two- and four-day lags and find our results (assuming a one-day lag) to be somewhat conservative, but overall quite similar. These results are available upon request.

of fund. We also conduct a nonparametric test of whether a significant majority (different from 50%) of the funds show an impact.

4.2. Dilution estimates

Panel A of Table 7 shows the average annualized dilution impact of daily fund flows on open-end mutual funds. Over our sample period of February 2, 1998 through March 31, 2000, the average annualized impact is −0.06% across all funds. This estimate is statistically different from zero at the 0.01 level. However, of the 833 mutual funds, 49% (statistically insignificantly different from 50%) have a positive impact. When examining the subsamples based on the mutual fund style, a clearer picture emerges. For bond funds, growth funds, and stock funds, the average and median dilution impact from fund flows is essentially zero, and slightly more than half of the sample funds have a positive impact estimate.

For international funds, we find significantly different results. The cross-sectional average (median) annualized dilution impact in international funds is −0.48% (−0.11%).[7] Only 29% of the 109 international funds have a positive impact. All of these results are statistically significant at the 0.01 level. This evidence suggests that market timers' fund flows adversely impact the passive investors in the international funds in our sample. For each fund, we calculate the dollar impact by multiplying the percentage impact for a fund by the fund's assets. For the international funds in our sample only, these results imply a total transfer of wealth from the passive fund shareholders to the market timers exceeding $420 million for the 26 months of our sample.

We next allow the data to tell us which funds are amenable to frequent exchanges. We presume that those funds in the upper 50% of fund flow activity within each style category are those for which more frequent fund exchanges are possible. Panel B of Table 7 examines the average impact conditional on the level of fund flows. Bond funds with within-style below-median average daily fund flows show no impact, while growth funds and stock funds have average impacts of *positive* seven and four basis points, respectively. While Eq. (5) shows that, all things equal, the larger the percentage flow, the larger the impact, the positive impact here on low-flow funds demonstrates the importance of considering the interaction (i.e., correlation) of flows and the following period's returns. Nearly 60% of the growth and stock funds have a positive impact, while 51% of the bond funds have a positive impact for low levels of fund flow activity. Below-median average daily flow level international funds have a statistically insignificant average impact of positive one basis point.

For the funds with high levels of fund flow activity, the annualized impact is statistically insignificant for bond, growth, and stock funds. However, high-flow international funds have an average (median) annualized dilution effect of −0.94% (−0.65%). Only 16% of these funds have a positive impact from fund flows. So, for

[7] When using only the 69 international funds that we unambiguously classify as "pre-flow" or "post-flow" (see Appendix A), we estimate an average annualized dilution impact of −0.57%.

Table 7
The dilution impact of fund flows on mutual fund returns
Cross-sectional distribution of annualized percentage impact due to the dilution effect of daily fund flows for open-end mutual funds from February 2, 1998 through March 31, 2000. The sample includes mutual funds followed by TrimTabs, Inc. whose objective is categorized as a bond fund, growth stock fund, international fund, or stock fund. The dilution effect is calculated assuming a one-day lag for investing new cash in risky assets. Panel A reports the unconditional results, while Panel B conditions on the median average daily flow level within each category.

Panel A: Full sample

	Full sample	Bond	Growth	Stock	International
Mean	−0.06%**	0.01%	0.00%	0.01%	−0.48%**
Std. dev.	0.47%	0.16%	0.44%	0.23%	0.95%
75%	0.05%	0.02%	0.13%	0.08%	0.03%
Median	0.00%	0.00%	0.00%	0.01%	−0.11%
25%	−0.06%	−0.01%	−0.13%	−0.06%	−0.68%
N	833	309	204	211	109
%Positive	49.0%	51.1%	49.5%	55.5%	29.4%***

Difference-in-means test *t*-statistic		Growth	Stock	International
	Bond	0.18	0.30	−5.30**
	Growth		0.33	−4.98**
	Stock			−5.30**

Panel B: Conditional on the level of fund flows

	Bond	Growth	Stock	International
Below median flow				
Mean	0.01%	0.07%**	0.04%**	−0.01%
Std. dev.	0.04%	0.20%	0.14%	0.18%
Median	0.00%	0.02%	0.01%	−0.01%
N	154	102	105	54
%Positive	51.3%	56.9%	61.9%***	42.6%
Above median flow				
Mean	0.01%	−0.06%	−0.01%	−0.94%**
Std. dev.	0.23%	0.59%	0.30%	1.16%
Median	0.00%	−0.08%	−0.01%	−0.65%
N	155	102	106	55
%Positive	51.0%	42.2%	49.1%	16.4%****
Difference-in-means *t*-statistic	−0.25	2.16*	1.63	5.86**

*Significant difference from zero at the 5% levels.
**Significant difference from zero at the 1% levels.
***Significant difference from 50% at the 5% levels.
****Significant difference from 50% at the 1% level.

those international funds that facilitate frequent trading, the impact of fund flows appears statistically and economically significant. A test of the average difference of the annualized impact between the two fund flow levels is statistically significant for growth and international funds.

4.3. Feasibility, exchange restrictions, and portfolio composition

Heretofore we have taken an ex post approach to the feasibility of profiting from stale-priced international funds. That is, we have assumed that the strategy is feasible in those funds in which we observe high fund flows. Ex ante, we would expect high fund flow levels and significant dilution only in funds with permissive exchange policies. Similarly, we would expect the magnitude of the dilution impact to vary by the potential "staleness" of the fund's NAV.

Some fund families state that they allow only a limited number of exchanges per year, while others put no limit on the number of exchanges. Virtually all fund families that we are aware of "reserve the right to limit exchanges", especially if they suspect market timing activity. Enforcement of limited exchange policies varies widely. We contacted over 30 fund families in late 1999. Approximately one-third of those with whom we spoke stated either that there are no restrictions on exchanges or that the restrictions are limits in print, but only sporadically enforced. Some funds, for example, state that they restrict large accounts or exchanges of $1 million or more, but do not monitor smaller accounts systematically. We justify our implicit a priori assumption that daily trading is feasible based on several observations. First, most 401k and 403b plan contracts have unlimited exchange features. Second, fund supermarkets allow traders to jump from one fund family to another, effectively bypassing fund families' restrictions. Finally, fund supermarkets and some 401k plans batch or net account trades into one "order" that is passed on to the fund family, which makes impossible the fund family's detection of individuals' trades. Though not systematic proof of the feasibility of frequent mutual fund exchanges, we are aware of traders who have successfully engaged in a daily mutual fund trading strategy in a number of mutual fund families for over three years.

To examine these issues, we partition the international fund sample according to stated exchange restrictions and portfolio composition. For the exchange restrictions, we search each fund's prospectus for stated exchange restrictions (e.g., "exchanges limited to four per year"), market timing language (e.g., "do not allow market timing"), exchange fees (e.g., "0.25% per exchange" or "$10 per exchange"), minimum holding periods (e.g., "may not exchange within seven days of last exchange"), and loads (e.g., front-end or deferred load). As noted earlier, any *stated* exchange policy can vary from the *effective* policy based on the level of monitoring or enforcement. Therefore, we expect the more operational restrictions, such as exchange fees and minimum holding periods, to have a larger impact on exchanges than the other policies, such as timing language and stated exchange restrictions. Table 8 shows the level of fund flows and the dilution impact for the sample funds partitioned by exchange restrictions. Only the "minimum holding period" results in significantly lower fund flows and less (in magnitude) dilution. While "exchange fees" show little effect on flows, we have little power to detect an effect in this case. Seven of the 17 "exchange fee" funds initiate fees during our sample period. We have found (but do not report in the table) a significant decrease in fund flows and dilution when funds initiate redemption fees. Interestingly, front-end load funds have significantly *higher* daily fund flows and more dilution. Our results suggest that

Table 8
fund flows and dilution impact conditional on trading restrictions and portfolio composition for international mutual funds
Daily fund flow and annualized dilution impact statistics are reported for subsamples partioned by exchange restrictions and portfolio composition. Classifications "with exchange restrictions" and "with timing language" are assigned if the prospectus states explicit limits on exchanges per year or mentions restrictions on market timing, respectively. Funds that charge redemption or trading fees for exchanges are classified as "with exchange fee" and funds that prohibit trading within a specified number of days upon entering a fund are classified as "with minimum holding period". Funds that have front-end loads are labeled "with front-end load". Funds with either a front-end or a deferred load are classified as "with front-end or deferred load". We also report the t-statistic on the test of the null hypothesis that the means between the two subsamples are the same. "Asian funds" and "European funds" hold primarily stocks that trade in Asian markets or European markets, respectively. "Emerging markets funds" hold stocks that trade predominantly in Latin American and other emerging markets. "World funds" have holdings across diverse regions of the world, possibly including significant holdings in the U.S. or Canada.

	Daily fund flows		Annualized dilution impact		
	Mean	Std. dev.	Mean	Std. dev.	N
With exchange restrictions	0.89%	0.98%	−0.47%	0.98%	50
Without exchange restrictions	0.93%	0.85%	−0.48%	0.93%	59
t-Test of equality of means	−0.22		0.03		
With timing language	0.87%	0.88%	−0.49%	0.99%	68
Without timing language	0.98%	0.97%	−0.46%	0.91%	41
t-Test of equality of means	−0.57		−0.15		
With exchange fee	0.95%	0.97%	−0.55%	1.50%	17
Without exchange fee	0.91%	0.90%	−0.46%	0.82%	92
t-Test of equality of means	0.16		−0.23		
With minimum holding period	0.49%	0.38%	−0.09%	0.50%	15
Without minimum holding period	0.98%	0.95%	−0.54%	0.99%	94
t-Test of equality of means	−3.54**		2.75%**		
With front-end load	1.54%	1.14%	−0.94%	1.02%	30
Without front-end load	0.67%	0.67%	−0.30%	0.87%	79
t-Test of equality of means	3.93**		−3.02**		
With front-end or deferred load	0.99%	1.00%	−0.49%	0.86%	61
No-load	0.82%	0.78%	−0.47%	1.07%	48
t-Test of equality of means	0.99		−0.17		
Asian funds	1.69%	1.19%	−1.64%	1.66%	14
European funds	1.06%	0.99%	−0.53%	0.84%	36
World funds	0.68%	0.68%	−0.19%	0.50%	48
Emerging markets funds	0.48%	1.61%	−0.08%	0.36%	11
F-Test of equality of means	6.55**		11.85**		

**Significant difference from zero at the 1% level.

market timers are more concentrated in front-end load funds compared with no-load or deferred load funds. The convention with front-end loads is that an investor is charged the load when entering the fund family. In nearly all cases, investors can exchange into and out of the funds within the same family without paying an additional load fee. Furthermore, most funds waive the load if investors return to the fund family within 90 days of a redemption.

The level of fund flows and the magnitude of the dilution impact also vary by the attractiveness of the fund for stale-price market timing purposes. Asian funds appear to offer the most potential for stale prices compared with European funds, since Asian markets are closed prior to the open of trading in the U.S. Similarly, funds with significant North American (e.g., U.S. or Canada) holdings, which we classify as "world" funds, should be less attractive to strategic traders. Finally, funds concentrating in emerging markets are least attractive to market timers since these funds tend to concentrate their holdings in Latin America. Table 8 shows that both fund flows and dilution are largest in Asian funds, with European funds, world funds, and emerging market funds having significantly lower average dilution and flows.

4.4. *Portfolio performance and dilution*

Daily fund flows offer precise information regarding the trading decisions of investors, including those of profit-seeking traders exploiting stale prices. Using these daily flows and the returns they capture, our dilution impact measure directly estimates the effect of fund flows on returns. To reinforce this claim, we estimate whether our dilution measure can explain variation in monthly fund returns. We augment the market model with a quadratic term to capture any manager-related market timing skill, and a coefficient on our dilution measure. This results in the following time-series regression for monthly fund returns:

$$r_t = \beta_0 + \beta_1 r_{m,t} + \beta_2 r_{m,t}^2 + \beta_3 \delta_t + \varepsilon_t, \tag{7}$$

where $r_{m,t}$ is the return on a market index and δ_t is the dilution measure for a fund in month t. Recall that $\delta_t < 0$ indicates that flows dilute returns. Therefore, a positive coefficient on the dilution measure would be consistent with our measure capturing the negative impact of dilutive flows on fund returns. For this analysis we aggregate all classes of each fund, since fund returns are most likely determined at the fund level rather than the class level.

Table 9 reports the cross-sectional distribution of the regression parameter estimates for both the full sample and the international funds. The coefficient on the dilution measure is positive on average. For international funds, the average coefficient estimate is statistically significant. Though we cannot reject that it is equal to one, we note that a point estimate greater than one could indicate that dilutive flows impose other costs on the fund, such as increased expenses or transaction costs, as in Edelen (1999).

Whether the dilution impact explains the cross-sectional distribution of common portfolio performance measures is an open question. As Edelen discusses, the mutual

Table 9

Portfolio performance and the dilution impact

This table reports the cross-sectional distribution of coefficient estimates of a market model of monthly fund returns with the addition of a component due to the dilution impact. For each fund we calculate the monthly dilution impact due to daily fund flows, δ_t, and the monthly return, r_t. We specify the market model using the CRSP value-weighted index return for domestic funds and the MSCI World Index return for international funds. Coefficient estimates are obtained for each fund using an estimation period of March 1998 through March 2000 for the model

$$r_t = \beta_0 + \beta_1 r_{m,t} + \beta_2 r_{m,t}^2 + \beta_3 \delta_t + \varepsilon_t.$$

The 833 (109) full sample (international) funds are aggregated so that there are not multiple classes of funds. This results in a sample of 705 (83) funds in the full (international) sample. The table reports the model specified both with and without the market-timing coefficient.

Coefficient on	β_0	β_1	β_2	β_3	R^2	N
Full sample						
Mean	−0.0013	0.69**		1.32	0.54	705
Std. dev.	0.0093	0.51		45.23	0.36	
%Positive	50.5%	79.1%****		55.0%****		
Mean	0.0001	0.67**	−0.44**	2.39	0.55	705
Std. dev.	0.0098	0.49	2.15	41.45	0.36	
%Positive	48.4%	84.0%****	47.5%	55.9%****		
International funds						
Mean	0.0015	1.10**		2.89*	0.65	83
Std. dev.	0.0130	0.28		14.02	0.19	
%Positive	62.7%***	100.0%****		71.1%****		
Mean	0.0073**	1.04**	−1.98**	2.79*	0.67	83
Std. dev.	0.0122	0.28	3.89	13.45	0.19	
%Positive	78.3%****	100.0%****	10.8%****	73.5%****		

*Significant difference from zero at the 5% level.

**Significant difference from zero at the 1% level.

***Significant difference from 50% at the 5% levels.

****Significant difference from 50% at the 1% levels.

fund manager could appear to be a poor market timer as a result of the dilution effect if investors with good timing performance trade mutual fund shares. He finds evidence consistent with this possibility by showing that market model estimates are significantly affected by the inclusion of fund flows in the model. Similarly, this effect could be consistent with evidence presented in Ferson and Schadt (1996) and Ferson and Warther (1996) that fund flows could be correlated with time-varying returns, leading to the apparent poor market timing performance of mutual fund managers.

A thorough analysis of how dilutive fund flows affect the measurement of portfolio performance is beyond the scope of this paper. However, our results suggest that the dilution effect is potentially an important consideration in estimating portfolio performance. Given that fund flows in some funds are correlated with subsequent market returns, the flows' impact on performance measures is uncertain, as discussed in Dybvig and Ross (1985) and Lehman and

Modest (1987). If dilutive fund flows cause a fund's cash holdings to vary with risky asset returns, then this could manifest itself in the fund's measured market timing performance, index sensitivity, or abnormal return, or some combination thereof.

5. Conclusions

We demonstrate empirically that a simple international fund trading rule based on one highly observable variable, daily S&P 500 returns, generates expected annualized returns of approximately 30% due to mutual funds' use of stale prices. We find patterns in daily fund flows consistent with traders who strategically exchange into and out of international funds to take advantage of short-term market returns that follow U.S. market movements. The gains to these traders, who induce well-timed fund flows in international funds, dilute the returns of the nontrading, or passive, shareholders. For international mutual funds exhibiting the highest level of fund flows, we estimate a –0.94% average annualized dilution impact on returns. For the 109 international funds in our full sample, representing approximately 20% of all international open-end mutual funds, we estimate an actual net transfer of wealth from passive investors to market timers in excess of $420 million over a 26-month period.

Chalmers et al. (2001) suggest that profit opportunities exist in domestic equity funds. We find little evidence of daily fund flows consistent with profitable trading in domestic funds and find no significant average dilution impact. One explanation of our results is that investors who "play" the wildcard option game by taking advantage of stale prices in mutual funds optimize their returns, given their limited capital. Since the most profitable opportunities exist in international funds, this is where these traders currently focus their efforts. If the opportunities in international funds dissipate (e.g., through enforcement of exchange restrictions), then these traders might focus their attention on domestic funds.

Collectively, this paper and the studies of Edelen (1999) and Brown et al. (2001) suggest that the design of open-end mutual funds is an important consideration in the study of performance and manager skill. Recently, many fund companies have revised their exchange policies to address the attempts of "market timers" to exploit stale prices (see, for example, TIAA-CREF's *Participant* magazine, November 1999, pp. 2–3; and *Business Week*, September 6, 1999, p. 74). For example, some fund companies have begun restricting fund exchanges to a few per month and/or are initiating "fair value" pricing on days of extremely high volatility. While these policies would appear to diminish the opportunities for any given market timer to trade daily, they do not eliminate the dilution impact. Specifically, if traders still find a strategy profitable, within the constraint of trading infrequently, then funds still could be faced with exchanges that dilute their returns. We leave for future research an analysis of the conditions under which a measurable impact is possible.

Though the returns earned by the strategic traders in this paper appear anomalous, one way in which these results can be viewed as consistent with an efficient market is that fund companies are free to set and enforce their exchange

policies. Meanwhile, investors are free to self-select into funds that meet their preferences regarding fund exchange privileges. Our results suggest that the passive investor is better off in the same fund absent well-timed fund flows. However, passive investors might choose a fund in which there is a large dilution impact from fund flows if that fund's manager can compensate for the negative impact with positive abnormal returns from selection or timing skill. Overall, our analysis suggests further consideration of mutual fund policies that allow dilutive trading and their consequent impact on investor welfare.

Appendix A. Timing of fund flows in TrimTabs, Inc data

Suppose a mutual fund begins day 1 with net assets of a_0, which originate from the end of the previous day. These assets begin day 1 valued at day 0's end-of-day price per share, p_0. As the day progresses, the mutual fund receives orders to exchange fund shares (purchases and/or sales). These orders are held to be transacted after calculating the end-of-day price for the fund's assets. At the end of day 1, the fund updates the value of its net assets to $\hat{a}_1$, reflecting the day's change in the underlying assets' prices, but not the day's flow. Using $\hat{a}_1$ and pre-flow shares outstanding, the fund calculates the per share net asset value (NAV), p_1. The fund then executes the exchange orders, f_1, at NAV, resulting in the fund's post-flow assets, $a_1 = \hat{a}_1 + f_1$. Thus, the fund begins day 2 with net assets of a_1. TrimTabs receives reports of the previous day's end-of-day net assets from mutual fund companies. The key question is whether funds report $\hat{a}_1$ or a_1 to TrimTabs.

A reliable source with which we can check the net assets in the TrimTabs data are the N-SAR and N-30D reports that mutual funds file semiannually with the SEC. These SEC-filed documents must be in accordance with GAAP, which require that the financial statements reflect post-flow (a_1) net assets (see *Audits of Investment Companies*, 1998, Chapter 3, Sections 3.13–3.24). Other sources of mutual fund net asset numbers, such as the CRSP mutual fund database and Morningstar reports, are also available. However, it is possible that CRSP and Morningstar rely on net asset numbers self-reported by mutual funds in a similar manner as TrimTabs. Therefore, if funds are consistent in their self-reporting to vendors, TrimTabs data can be misclassified as post-flow (pre-flow) if a false assumption is made that CRSP or Morningstar is post-flow (pre-flow) when checked against these alternative sources. For example, Goetzmann et al. (2001) check TrimTabs net asset numbers against CRSP and find that virtually all observations between the two sources are the same. Since they have assumed that CRSP data are post-flow, they classify their sample as post-flow. Since the SEC filings must conform to GAAP by reporting post-flow data, they are a reliable and independent starting point against which to check the TrimTabs data in this matter.

Since N-SARs are machine-readable, we start with them for all of the funds in our sample during our sample period. The N-SARs have the drawback that they do not always break down the net asset numbers by class within a fund. Therefore, we are not able to match all funds in our sample with N-SAR data, since we treat different

classes of the same fund as separate funds. For these funds, we also search for N-30D data. Since N-SARs and N-30Ds are filed semiannually, we potentially have up to five observations per fund in our 26-month sample window. We match the N-SAR and N-30D data with our TrimTabs data using the fund name and date, matching N-SARs dated on weekends with the prior Friday. Taking the N-SAR date as date t, and the TrimTabs asset number on that date as x_t, we calculate $\hat{x}_t = x_{t+1}(p_t/p_{t+1})$. We attempt to determine whether x_t or $\hat{x}_t$ matches the N-SAR and N-30D post-flow net assets. For these two net assets, we take the absolute percentage error from the N-SAR (or N-30D) net assets. If the x_t has a lower absolute percentage error then we categorize the observation as post-flow. If $\hat{x}_t$ has a lower absolute percentage error then we categorize the observation as pre-flow. We require that the absolute percentage error of the "matched" asset number (x_t or $\hat{x}_t$) be within a tolerance of 2%. Otherwise, we categorize the observation as *no match*. Additionally, in cases where x_t is exactly the same as $\hat{x}_t$, we categorize the observation as a *draw*.

The goal is to categorize each *fund* in our sample as pre-flow or post-flow. Once we have done this, we can calculate the daily flow for our sample funds and be confident of the timing of these calculations. For the funds in our sample with which we can match N-SAR or N-30D data, Panel A of Table 10 breaks down how the observations are categorized. Across our sample of 833 funds, we have 1,649 observations. We have multiple observations for many funds in our sample and no

Table 10

Classification of TrimTabs funds as reporting pre-flow or post-flow net assets

We match TrimTabs' reported net assets with the net assets reported in N-SAR and N-30D filings with the SEC. Panel A reports the how we classify observations. When pre- and post-flow assets are the same in TrimTabs, we classify the observation as a draw. We classify observations where neither pre-flow nor post-flow assets match the N-SAR or N-30D with a 2% tolerance. Panel B reports how a fund is classified. We use a unanimous rule first where all observations of a fund are pre- or post-flow. Non-classified funds are then classified by a majority of observations within the fund, within other classes of the same fund, using other funds in the same family, and the full-sample majority.

Panel A: Classification of observations from N-SAR and N-30D data

Classification	Number	% of sample	Pre-flow abs % error	Post-flow abs % error
Draw	35	2.1	—	—
No match (outside tolerance)	87	5.3	—	—
Pre-flow	963	58.4	0.05	0.47
Post-flow	564	34.2	0.43	0.08

Panel B: Classification of funds

Method of classification	Pre-flow	Pre-flow total	Post-flow	Post-flow total	Total classified
Unanimous within fund	331	331	157	157	488
Majority within fund	87	418	46	203	621
From other classes of fund	20	438	6	209	647
From fund family	124	562	47	256	818
From full sample	15	577	0	256	833

observations for some funds in our sample, since some N-SARs and N-30Ds do not break out assets across classes of funds. Therefore, we take the following approach to categorize a fund in our sample as pre-flow or post-flow. We discard the no match and draw observations, since they offer us no reliable information toward our goal. This leaves us with no reliable observations for 99 funds, one observation per fund for 234 funds, two observations for 227 funds, and at least three observations for the remaining 273 funds. Funds for which all observations for that fund are "pre-flow" ("post-flow") are categorized as pre-flow (post-flow) funds. This "unanimous rule" categorizes 488 of our 833 funds (331 as pre-flow and the remaining 157 as post-flow). Other than the 234 funds for which there is only one observation, 130 funds are classified under the "unanimous rule" based on two observations, while the remaining 124 funds are classified using three or four observations. The "unanimous rule" classification uses multiple observations for 64% of the international funds, compared with 50% of the other fund types.

In some cases, the N-SAR and N-30D data reveal that a fund has pre-flow data using one date's observation, but post-flow data using another date's observation. For these funds, we use "majority rules"— classifying the funds depending on the majority of observations. This classifies an additional 133 funds (87 as pre-flow). Remaining are 212 funds for which we could not find matching N-SAR or N-30D data, or for which we could find no non-"draw" observations that match either pre- or post-flow assets within our tolerance constraint. In some cases, these are different classes of funds that we have already classified. Therefore, we next rely on the classification of the other classes of the same fund to classify 26 more funds (20 as pre-flow). For funds unclassified thus far, we rely on each fund family's majority to classify 124 as pre-flow and 47 as post-flow. In the remaining 15 unclassified funds, we assign them as pre-flow, since the strong majority of funds in the overall sample are found to be pre-flow. Panel B of Table 10 summarizes these results.

As mentioned in the text, TrimTabs calculates the flow on day t as $f_t = (x_t - x_{t-1})p_t/p_{t+1}$. Since this is only accurate for post-flow funds, we must adjust the pre-flow funds' flow. We do this by noting that the fund flow calculated by TrimTabs for pre-flow funds on date $t+1$ is actually date t flow, inflated by the fund's return on date $t+1$. In our analysis, we assign the deflated flow from date $t+1$ to date t for the pre-flow funds and leave the post-flow funds' flow unadjusted.

For robustness checks, we conduct all of the analysis in this paper using only the 488 funds for which we have unanimous observations as pre- or post-flow and a subsample of these funds for which we have multiple observations. The results of the paper are unaffected. Indeed, the dilution effect for the full sample of international funds that we report in the paper is a bit conservative compared with a dilution effect for the "unanimous" sample (–0.48% and –0.57%, respectively). We note here that the proportion of pre-flow funds outweighs the proportion of post-flow funds by two to one and is relatively constant across all fund categories (bond, growth, stock, and international). Finally, there appears to be no time trend with respect to matching TrimTabs' asset numbers as pre- or post-flow asset numbers.

Our results differ from the inferences made by Goetzmann, Ivkovic, and Rouwenhorst (2001) (GIR), who use the monthly observations in the CRSP mutual

fund database to check the net asset numbers of TrimTabs during the 1998 and 1999 sample periods. Conclusions drawn by matching against the CRSP database are questionable. In fact, TrimTabs reported to us that, in TrimTabs' own "audit" of one mutual fund family that has over 20 funds in our sample across all categories (four international), they found (as did we) that this fund family systematically reported pre-flow assets to them. In contrast, GIR report that the CRSP data classifies only three funds in their entire sample as pre-flow. Since GIR report that virtually all of their TrimTabs observations match with the CRSP data, we infer that the CRSP data also reflect (daily) pre-flow assets. In spot-checks of several funds in our sample that we classify as "pre-flow" we find that the 1998 and 1999 CRSP and Morningstar databases match each other and match TrimTabs, but that the observations do not match the GAAP-conforming financial statements. In all cases with these funds, the one-day adjustment to the TrimTabs data results in a match with the GAAP-conforming financial statements, reinforcing our confidence in our pre-flow classifications. Finally, we note that we would not tend to classify funds as pre-flow erroneously if the financial statement (SEC) data are pre-flow. In this case, the more likely bias would be to classify funds as post-flow. On the other hand, if the TrimTabs, CRSP, and SEC data are all post-flow, it is very unlikely that our methodology would spuriously classify the majority of our sample funds as pre-flow.

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PREPARED STATEMENT OF WILLIAM H. DONALDSON

CHAIRMAN, U.S. SECURITIES AND EXCHANGE COMMISSION

NOVEMBER 18, 2003

Introduction

Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee, thank you for inviting me to testify today on the Securities and Exchange Commission's initiatives to address problems in the mutual fund and brokerage industries. When I testified before you on September 30, the discovery of late trading and market timing abuses by personnel at hedge fund Canary Capital had just erupted. I will update you on recent developments since then. First, though, I would like to share with you the fundamental rights that I believe every mutual fund investor not only should expect, but also to which every investor is entitled. We all—regulators, legislators, investment advisers, mutual fund managers, broker-dealers, the financial press and investors—have spent much time lately wondering how the current abuses could have happened. I believe that a significant reason is because the industry lost sight of certain fundamental principles—including its responsibilities to the millions of people who entrusted their confidence, the fruits of their labor, their hopes and dreams for the future to this industry for safekeeping. These investors are entitled to honest and industrious fiduciaries who sensibly put their money to work for them in our capital markets. No one can argue with the premise that investors deserve a brokerage and mutual fund industry built on fundamentally fair and ethical legal principles.

Let me outline my visions of "Mutual Fund Investors' Rights" and the critical initiatives underway at the Commission to ensure that these enhanced investor protections continue to be carried out and that our new investor protections are put in place as quickly as possible.

Mutual Fund Investors' Rights

Mutual Fund Investors Have a Right to an Investment Industry that is Committed to the Highest Ethical Standards and that Places Investors' Interests First

Every brokerage and mutual fund firm needs to conduct a fundamental assessment of its obligations to its customers and shareholders. These assessments must be put forth at the highest levels, and implemented so as to reach all employees. Senior management and the boards of directors must be ready to lay down and vigorously enforce rules that define an immutable code of conduct.

Investors Have a Right to Equal and Fair Treatment by Their Mutual Funds and Brokers

Our examinations and investigations of late trading and market timing abuses have revealed instances of special deals and preferential treatment being afforded to large investors, often to the detriment of small investors. The concepts of equal and fair treatment of all investors and the prohibition against using unfair informational advantages are embedded in various provisions of the Federal securities laws, including the Investment Company Act. The SEC will not tolerate arrangements of this kind that violate these fundamental principles.

Investors Have a Right to Expect Fund Managers and Broker-Dealers to Honor Their Obligations to Investors in Managing and Selling Funds

Our examinations and investigations into the current abuses have revealed instances of fund managers placing their interests—and in the case of some portfolio managers, placing their personal interests—ahead of those of fund investors. We also have seen recent examples of abusive activity by broker-dealers and their representatives in connection with the sale of fund shares, including failure to give investors the breakpoint discounts to which they are entitled, recommendations that investors purchase one class of shares over another in order for the salesperson to receive higher compensation and other sales practice abuses. This cannot and will not be tolerated.

Investors Have a Right to the Assurances that Fund Assets Are Being Used for Their Benefit

Clearly, fund assets, including use of a fund's brokerage commissions, must be used in a manner that benefits fund investors. The Commission must engage in a reassessment of how fund commission dollars are used, including various soft-dollar arrangements and the lack of transparency to investors of these payments.

Investors Have the Right to Clear Disclosure of Fees, Expenses, Conflicts, and Other Important Information

Mutual fund investors must have the tools and the information to make intelligent investment decisions. To that end, the Commission will take action to enhance disclosure to fund investors of fees and expenses, and the conflicts that arise as a result of the various arrangements between funds and brokers regarding the sale of fund shares, as well as other important information.

Investors Have a Right to Independent, Effective Boards of Directors Who Are Committed to Protecting Their Interests

In the words of the U.S. Supreme Court, the independent directors are the "independent watchdogs" that provide a critical and necessary check on fund management. The investors need to be assured that their mutual fund directors have the independence and commitment necessary to carry out this crucial function. We are proposing to set enhanced standards for board independence and are considering other steps in this area.

Investors Have a Right to Effective and Comprehensive Mutual Fund and Broker Compliance Programs

Programs designed to ensure compliance with the Federal securities laws are an essential tool in the protection of investors. Fund investors need to be assured that all funds, advisers and selling brokers have internal programs to ensure compliance with the Federal securities laws. We will complete our pending rulemaking to strengthen procedures at mutual funds and advisers.

Investors Should Expect that Aggressive Enforcement Actions Will Be Taken When There Are Violations of the Federal Securities Laws

We will continue to take strong and appropriate action against those who violate the Federal securities laws. There will be serious consequences to those who violate the Federal securities laws.

By holding the industry (and ourselves) to these standards, we can significantly minimize the possibility of future scandals that harm our Nation's millions of mutual fund investors, and help restore the confidence of those investors.

SEC Risk Management Initiative

For too long, the Commission has found itself in a position of reacting to market problems, rather than anticipating them. There are countless reasons for this—not the least of which include historically lagging resources and structural and organizational roadblocks. The time for excuses has long passed.

Since coming to the Commission in February, one of my top priorities has been to reevaluate and determine how the Commission deals with risk. Part of this evaluation has been a thorough review of the Commission's internal structures. The results of our work form a new risk management initiative that will better enable the Commission to anticipate, identify, and manage emerging risks and market trends that stand to threaten the Commission's ability to fulfill its mission.

This critical initiative—the first of its kind at the Commission—will enable us to analyze risks across divisional boundaries, focusing on early identification of new or resurgent forms of fraudulent, illegal, or questionable behavior or products. Operating under the "Doctrine of No Surprises," this initiative seeks to ensure that senior management at the Commission has the information necessary to make better, more informed decisions.

The new initiative will be housed within a newly created Office of Risk Assessment, and will be headed by a director who reports directly to the Chairman. The director will coordinate and manage risk assessment activities across the agency, and will oversee a staff of five professionals, who will focus on the key programmatic areas of the agency's mission.

The duties of the Office of Risk Assessment will be focused on the following areas:

- Gathering and maintaining data on new trends and risks from a variety of sources—including external experts, domestic and foreign agencies, surveys, focus groups, and other market data, including both buy-side and sell-side research.
- Analyzing data to identify and assess new areas of concern across professions, companies, industries, and markets.
- Preparing assessments and forecasts on the agency's risk environment.

The work of the Office of Risk Assessment will be complemented by a Risk Management Committee, whose primary responsibility will be to review the implications of identified risks and recommend an appropriate course of action.

Additionally, each Division and major Office will have one-to-two risk assessment professionals on staff, who will work closely with the Division Director or Office head as part of risk management teams to conduct risk assessment activities within each division.

I believe this important initiative will fundamentally change the way the Commission assesses risk and will enable us to head off major problems before they occur.

Plan of Execution

The SEC is dedicated to the underlying concept inherent in this statement: "Mutual Fund Investors' Rights." Let me outline what the specific initiatives to ensure that Mutual Fund Investors' Rights are realized.

Late Trading and Market Timing Abuses

Late trading and market timing abuses represent the most recent violations against investors' rights. In addition to those abuses, we have seen other violations of investors' rights, including (to name but a few) violations of an investor's right to high ethical standards, fiduciary protections, clear disclosure, and equal treatment. While we are vigorously pursuing enforcement actions regarding this misconduct, we also are taking a number of regulatory steps immediately to deal specifically with these abuses. On October 9, I outlined a regulatory agenda to confront the abuses head-on to help restore investor confidence in the fairness of mutual fund operations and practices. I asked the staff to submit rulemaking recommendations to the Commission this month to address these issues. As a result, on December 3, the Commission will consider the staff's proposal to require that a fund (or certain designated agents)—rather than an intermediary such as a broker-dealer or other unregulated third party—receive a purchase or redemption order prior to the time the fund prices its shares (typically, 4 p.m.) for an investor to receive that day's price. This "hard" 4 o'clock cut-off would effectively eliminate the potential for late trading through intermediaries that sell fund shares.

With respect to market timing abuses, we will consider the staff's recommendation that the Commission require additional, more explicit disclosure in fund offering documents of market timing policies and procedures. This disclosure would enable investors to assess a fund's market timing practices and determine if they are in line with their expectations.

The staff's recommendations will have a further component of requiring funds to have specific procedures to comply with their representations regarding market timing policies. Thus, if a fund's disclosure documents stated that it discouraged market timing, the fund would be required to have procedures outlining the practices it follows to keep market timers out of the fund. While our examination staff will use a variety of techniques to police for market timing abuses, the establishment of formal procedures would also enable the Commission's examination staff to review whether those procedures are being followed and whether the fund is living up to its representations regarding curbing market timing activity. The Commission also will emphasize the obligation of funds to fair value their securities so as to avoid "stale pricing" to minimize market timing arbitrage opportunities as an important measure to combat market timing activity.

Also on December 3, the Commission will consider adopting new rules under the Investment Company Act and the Investment Advisers Act that will ensure that mutual funds have strong compliance programs. Specifically, the rules that the Commission will consider would require each investment company and investment adviser registered with the Commission to: (1) adopt and implement written policies and procedures reasonably designed to prevent and detect violations of the Federal securities laws; (2) review these polices and procedures annually for their adequacy and the effectiveness of their implementation; and (3) designate a chief compliance officer to be responsible for administering the policies and procedures and to report directly to the fund's board of directors. A chief compliance officer reporting to the fund's board of directors will strengthen the hand of the fund's board and compliance personnel in dealing with fund management.

Allegations of certain portfolio managers market timing the funds they personally manage or other funds in the fund complex raise issues regarding self-dealing. Recent allegations also indicate that some fund managers may be selectively disclosing their portfolios in order to curry favor with large investors. Selective disclosure of a fund's portfolio can facilitate fraud and have severely adverse ramifications for a fund's investors if someone uses that portfolio information to trade against the fund. You can expect that these issues will also be addressed in the rulemaking recommendations that the Commission will consider on December 3.

The package of reforms that I have just outlined for you is designed to provide immediate reassurances and protection to mutual fund investors. They deserve

nothing less than an immediate response from the SEC. These critical reforms not only will tackle the immediate problem of late trading and market timing abuses that we have seen so far during our investigation, but also will provide powerful tools to prevent the types of abuses identified to date. However, we cannot and will not stop here. We will explore the full range of our authority, not only in the reforms discussed above, but also in the additional areas to further address market timing abuses.

For instance, while the Commission's actions regarding fair value pricing should address the problem of stale pricing (which facilitates market timing), we will consider more in this area. As such, I have asked the staff to study additional measures for Commission consideration, including considering a mandatory redemption fee imposed on short-term traders and developing a solution to the problem of trading through omnibus accounts.

With respect to the mandatory redemption fee, which would be paid to the fund (and, ultimately to the fund's long-term investors), it is a fee that would apply to short-term traders getting in and out of a fund over a short period of time, for instance 3 or 5 days. Such a fee could decrease the likelihood of market timers profiting from arbitrage activity.

As for omnibus accounts, I believe that there needs to be better information shared between funds and brokers. Mutual fund shares often are purchased and redeemed through omnibus accounts held at intermediaries such as broker-dealers. Typically, a brokerage firm has one omnibus account with each of the mutual funds with which it does business and through which all of its brokerage customers purchase and redeem shares of those mutual funds. Consequently, these mutual funds do not have information on the identity of the underlying brokerage customer who is purchasing or redeeming the funds' shares.

This arrangement often makes it difficult for funds to fulfill certain of their obligations to their shareholders. In the breakpoint context, omnibus accounts make it difficult for funds to track information about the underlying shareholder that might have entitled the shareholder to breakpoint discounts. In the market timing context, funds are not able to assess redemption fees, limit exchanges or even kick out a shareholder who is market timing through an omnibus account because they do not know the identity of that shareholder. Indeed, many of the market timing abuses identified through our examinations and investigations indicate that shareholders were market timing through omnibus accounts.

The issue is further complicated because brokers are reluctant to release the underlying shareholder information to funds, citing privacy and competitive concerns. The brokers fear that by releasing the names of their customers who are purchasing fund shares to the funds themselves, the funds then can market directly to those customers, cutting out the brokers.

Requiring broker-dealers and other intermediaries to provide information to funds regarding the funds' investors would allow funds to police for abusive market timing activity and to further provide for appropriate breakpoints. An alternative would be to require that broker-dealers and other intermediaries enforce funds' policies with respect to market timing and the offering of breakpoints.

Study

To assist the staff as it moves forward in considering this issue, I have called upon the NASD to head an Omnibus Account Task Force consisting of members of the fund and brokerage industries, as well as other intermediaries to further study this issue and to provide the SEC staff with information and recommendations. Under the NASD's capable leadership, the Joint NASD/Industry Task Force on Breakpoints was extremely beneficial in dealing with the breakpoint issue and I am confident that, working together with the NASD and the industry, we will be able to develop a proposal that will adequately address the omnibus account issue.

Fund Governance

As I noted, a fundamental right of investors is a strong, effective, independent board of directors. The statutory framework governing mutual funds envisions a key role for boards of directors in light of the external management structure typical for funds. The directors, particularly the "independent directors," are responsible for managing conflicts of interest and representing the interests of shareholders. The problems that recently have come to light underscore the need for enhanced effectiveness of independent directors in carrying out their responsibilities. Toward that end, I believe there are a number of ideas for reform, including:

- Requiring an independent chairman of the fund's board of directors.
- Increasing the percentage of independent directors under the SEC's rules from a majority to three-fourths.

- Providing the independent directors with the authority to retain staff as they deem necessary so they do not have to necessarily rely on the fund's adviser for assistance.
- Requiring boards of directors to perform an annual self-evaluation of their effectiveness, including consideration of the number of funds they oversee and the board's committee structure.
- Adopting a rule that would require boards to focus on and preserve documents and information that directors use to determine the reasonableness of fees relative to performance, quality of service and stated objectives, including a focus on the need for breakpoints or reductions in advisory fees and comparisons with fees and services charged to other clients of the adviser.

I recognize, however, that while the Commission can adopt rules to enhance and strengthen fund governance, that is not enough. Directors themselves must understand and carry out their responsibilities to protect fund investors. We need to take the necessary steps to educate directors regarding this crucial role and to ensure that they understand their role. Accordingly, in addition to asking the staff to develop these reforms for consideration by the Commission in January, I have also called upon fund independent directors themselves to be active participants in the reform effort. Specifically, I have asked former SEC Chairman David Ruder's non-profit mutual fund director's organization, the Mutual Fund Directors Forum, to develop guidance and best practices in key areas of director decisionmaking, such as monitoring fees and conflicts, overseeing compliance, and important issues such as valuation and pricing of fund portfolio securities and fund shares. Mr. Ruder and the Board of Directors of the Forum—an organization geared toward independent directors and that promotes improved fund governance through continuing education programs and other activities that assist independent directors in advocating for fund shareholders—have agreed to develop this guidance and these best practices to assist independent directors. Rest assured, we will continue to consider every viable idea, from whatever source, for improving the way that mutual funds are structured and governed.

In addition to these initiatives, in August of this year the Commission proposed rules regarding disclosure of fund nominating committee functions and communications between fund investors and fund boards, as part of the Commission's broader proposal on nominating committee disclosure. And just last month, the Commission, as part of its broader proxy nomination proposal, proposed rules to improve access of fund shareholders to the director nomination proxy process.

Disclosure

Another fundamental right of mutual fund investors is clear, easy to understand disclosure. At the end of September, we adopted amendments to mutual fund advertising rules that require that fund advertisements state that investors should consider fees before investing and that advertisements direct investors to a fund's prospectus to obtain additional information about fees. The rules also require more balanced information about mutual funds when they advertise performance. The Commission also recently proposed rule amendments regarding fund of funds products that would require these products to include additional disclosure in their prospectus fee table of the costs of investing in underlying funds. The Commission also adopted rules that require funds and advisers to disclose their proxy voting policies and procedures and, in the case of funds, disclose to investors the voting records of the funds.

Another key concept of the disclosure principle is clear, easy to understand disclosure to mutual fund investors of the fees and expenses they pay. I anticipate that in January, the Commission will consider adopting rules that would require "dollars and cents" fee disclosure to shareholders, coupled with more frequent disclosure of portfolio holdings information. This is an important reform, as it will allow investors to determine not only the fees and expenses they are paying on their particular funds, but will also greatly facilitate comparison among different funds. The Commission also will be considering in December a proposal to improve disclosure to shareholders regarding the availability of sales load breakpoints. We also want to provide investors better information on portfolio transaction costs so that they can factor this into their decisionmaking. Consequently, the staff is developing for Commission consideration in December a concept release to solicit views on how the Commission should proceed in fashioning disclosure of these costs.

Investors not only deserve to know the fees and expenses their funds pay, they also deserve to know how much their broker stands to benefit from their purchase of a particular fund. Thus, we also plan to improve disclosure about mutual fund transaction costs through the confirmations that broker-dealers provide to their cus-

tomers. I have directed the staff to prepare a new mutual fund confirmation statement that will provide customers with quantified information about the sales loads and other charges that they incur when they purchase mutual funds with sales loads. I expect that the Commission will consider this proposal before the end of the year. The Commission also will direct the staff to consider how disclosure of quantified information about sales loads and other charges incurred by investors might be disclosed in a document available prior to the sale of fund shares.

To address an investor's right to know about conflicts of interest that brokers may have when selling fund shares, the new mutual fund confirmation statement also will include specific disclosure regarding revenue sharing arrangements, differential compensation for proprietary funds and for other incentives such as commission business for brokers to sell fund shares that may not be readily apparent to fund investors.

To ensure that investors receive the benefits of fund assets to which they are entitled, the Commission will examine how brokerage commissions are being used to facilitate the sale and distribution of fund shares, as well as the use of so-called soft-dollar arrangements. Soft-dollar arrangements can create incentives for fund advisers to: (1) direct fund brokerage based on the research provided to the adviser rather than on the quality of execution provided to the fund; (2) forgo opportunities to recapture brokerage costs for the benefit of the fund; and (3) cause the adviser to over-trade the portfolio to fulfill its soft-dollar commitments to brokers. These are areas that raise complicated issues, but that we will nevertheless examine.

I have also instructed the staff to consider rules that would better highlight for investors the basis upon which directors have approved management and other fees of the fund.

Compliance and Oversight

The Commission long has recognized the importance of strong internal controls. For example, the Commission recently tailored the provisions of the Sarbanes-Oxley Act to apply to mutual funds, including the provisions to improve oversight and internal controls, such as key officer certifications and Code of Ethics requirements, thereby ensuring that mutual fund shareholders received the full protections of the Sarbanes-Oxley Act.

In addition, I should note that the staff in September issued a comprehensive report on hedge funds, making a series of recommendations to improve the Commission's ability to monitor the activity of these vehicles—the most significant being a recommendation to require that hedge fund advisers register under the Investment Advisers Act and thereby become subject to Commission examination and routine oversight. This review of hedge funds, and the staff's recommendations, become all the more important when we consider that we have seen a number of hedge funds allegedly engaging in late trading and market timing of mutual fund shares, serving as the impetus for the current investigations and enforcement actions related to these activities.

We will continue to explore additional approaches that the Commission might pursue to require funds to assume greater responsibility for compliance with the Federal securities laws, including whether funds and advisers should periodically undergo an independent third-party compliance audit. These compliance audits could be a useful supplement to our own examination program and could ensure more frequent examination of funds and advisers.

Also, as an effective regulator, we must have clear rules as to what is unlawful activity. We will continue to review our rules and our regulations to ensure that this is the case, much as we are doing now to combat late trading and market timing abuses.

Actions on the Enforcement Front

Again, I believe that these investor rights are critical. Equally critical is effective enforcement of those rights and of the Federal securities laws.

When I testified before you in September, I noted that the Commission had taken immediate enforcement action against a senior official at Bank of America. Since then, we have taken a number of additional enforcement actions against those taking part in these trading abuses.

We have charged a senior executive of a prominent hedge fund with late trading, and barred him from association with an investment adviser. We also barred and imposed a $400,000 civil penalty on a mutual fund executive in connection with his alleged role in allowing certain investors to market time his company's funds. We instituted an action against a major investment management firm and two of its portfolio managers who allegedly market timed their own mutual funds. And we charged five brokers and a branch manager with having misrepresented or con-

cealed their own and their clients' identities in order to facilitate thousands of market timing transactions.

Putnam Settlement

Among its many roles, the Securities and Exchange Commission has two critical missions. The first is to protect investors, and the second is to punish those who violate our securities laws. Last week's partial settlement of the SEC's fraud case against the Putnam mutual fund complex does both. It offers immediate and significant protections for Putnam's current mutual fund investors, serving as an important first step. Moreover, by its terms, it enhances our ability to obtain meaningful financial sanctions against alleged wrongdoing at Putnam, and leaves the door open for further inquiry and regulatory action.

Despite its merits, the settlement has provoked considerable discussion, and some criticism. Unfortunately, the criticism is misguided and misinformed, and it obscures the settlement's fundamental significance.

By acting quickly, the SEC required Putnam to agree to terms that produce immediate and lasting benefits for investors currently holding Putnam funds. First, we put in place a process for Putnam to make full restitution for investor losses associated with Putnam's misconduct. Second, we required Putnam to admit its violations for purposes of seeking a penalty and other monetary relief. Third, we forced immediate, tangible reforms at Putnam to protect investors from this day forward. These reforms are already being put into place, and they are working to protect Putnam investors from the misconduct we found in this case.

Among the important reforms Putnam will implement is a requirement that Putnam employees who invest in Putnam funds hold those investments for at least 90 days, and in some cases for as long as 1 year—putting an end to the type of short-term trading we found at Putnam. On the corporate governance front, Putnam fund boards of trustees will have independent chairmen, at least 75 percent of the board members will be independent, and all board actions will be approved by a majority of the independent directors. In addition, the fund boards of trustees will have their own independent staff member who will report to and assist the fund boards in monitoring Putnam's compliance with the Federal securities laws, its fiduciary duties to shareholders, and its Code of Ethics. Putnam has also committed to submit to an independent review of its policies and procedures designed to prevent and to detect problems in these critical areas—now, and every other year.

This settlement is not the end of the Commission's investigation of Putnam. We are also continuing to examine the firm's actions and to pursue additional remedies that may be appropriate, including penalties and other monetary relief. If we turn up more evidence of illegal trading, or any other prohibited activity, we will not hesitate to bring additional enforcement actions against Putnam or any of its employees. Indeed, our action in Federal court charging two Putnam portfolio managers with securities fraud is pending.

There are two specific criticisms of the settlement that merit a response. First, some have charged that it was a mistake not to force the new management at Putnam to agree that the old management had committed illegal acts. In fact, we took the unusual step of requiring Putnam to admit to liability for the purposes of determining the amount of any penalty to be imposed. We made a decision, however, that it would be better to move quickly to obtain real and practical protections for Putnam's investors, right now, rather than to pursue a blanket legal admission from Putnam. The SEC is hardly out of the mainstream in making such a decision. All other Federal agencies, and many State agencies (including that of the New York Attorney General), willingly and regularly forgo blanket admissions in order to achieve meaningful and timely resolutions of civil proceedings.

Second, some have criticized the Putnam settlement because it does not address how fees are charged and disclosed in the mutual fund industry. While this issue is serious, the claim is spurious. The Putnam case is about excessive short-term trading by at least six Putnam management professionals and the failure of Putnam to detect and deter that trading. The amount and disclosure of fees is not, and never has been, a part of the Putnam case, and thus it would be wholly improper to try to piggyback the fee disclosure issue on an unrelated matter.

If our continuing investigation of Putnam uncovers evidence of wrongdoing in the fee disclosure area, we will not hesitate to act, and the Commission is already moving forward with rulemaking that will address this issue, and others, on an industrywide basis. Those lacking rulemaking authority seem to want to shoehorn the consideration of the fee disclosure issues into the settlement of lawsuits about other subjects. But we should not use the threat of civil or criminal prosecution to extract concessions that have nothing to do with the alleged violations of the law.

Criticism of the Commission for moving too quickly misses the significance of the Commission's action. While continuing our broader investigation of Putnam, we have reached a fair and far-reaching settlement that establishes substantial governance reforms and compliance controls that are already benefiting Putnam's investors. It is a settlement where the Commission put the interests of investors first. As the Commission continues to initiate critical and immediate reforms of the mutual fund industry, and while we investigate a multitude of other cases involving mutual fund abuses, we will continue to seek reforms that provide immediate relief to harmed investors.

I also want briefly to discuss yesterday's announcement of the Commission's enforcement action against Morgan Stanley arising out of the firm's mutual fund sales practices. Morgan Stanley has agreed to a settlement of the action that calls, in part, for it to pay a total of $50 million, all of which will be returned to investors. The action grows out of an investigation begun in the spring of this year.

The Commission's investigation uncovered two distinct, firm-wide disclosure failures by Morgan Stanley. The first relates to an exclusive program involving sixteen mutual fund families that Morgan Stanley sold to its customers under an exclusive program involving 16 mutual fund families.

Under the program, Morgan Stanley gave these fund families what is sometimes called "premium shelf space." The firm encouraged its sales force to sell shares of the funds in the program and even paid its salespeople special incentives to sell those funds so that Morgan Stanley would receive from those funds a percentage of the sales price over and above ordinary commissions and loads. Morgan Stanley's customers did not know about these special shelf-space payments, nor in many cases they did not know that the payments were coming out of the very funds into which these investors were putting their savings.

Few things are more important to investors than receiving unbiased advice from their investment professionals. Morgan Stanley's customers were not informed of the extent to which Morgan Stanley was motivated to sell them a particular fund.

Our investigation also uncovered, and the enforcement action we have filed includes, another practice at Morgan Stanley involving conflicts of interest in the sale of mutual funds. This practice, which has been the subject of other Commission cases during the last several months, involves the sale of Class B mutual fund shares to investors who were more likely to have better overall returns if they bought Class A shares in the same funds.

I want to emphasize that the abuses that are addressed in this case are significant and are not necessarily limited to Morgan Stanley. So-called shelf-space payments have become popular with brokerage firms and the funds they are selling. Thus, the Commission is conducting an examination sweep of some 15 different broker-dealers to determine exactly what payments are being made by funds, the form of those payments, the "shelf space" benefits that broker-dealers provide, and most importantly, just what these firms tell their investors about these practices. I also want to note that the potential disclosure failures and breaches of trust are not limited to broker-dealers. We are also looking very closely at the mutual fund companies themselves.

The SEC's Director of Enforcement, Stephen Cutler, will be testifying before you on our enforcement efforts this Thursday, and can answer your specific questions about these and the Commission's other enforcement actions, as well as the results thus far in our ongoing investigation. While he cannot speak to specific entities that the Commission has authorized the staff to investigate, he can brief you on the types of cases you likely will be seeing brought by the Commission in the near future. Let me emphasize, however, that I am appalled at the types and extent of conduct that is being revealed in our examinations and investigations. It is conduct that represents fundamental breaches of fiduciary obligations and betrayal of our Nation's investors. I can assure you that we are committed to seeking redress for investors and meting out the appropriate punishment in these matters to send a strong message that these types of abuses will not be tolerated.

Conclusion

As you can see, taken together, the reforms that the Commission has already undertaken and those currently being initiated are both substantial and far-reaching. They are designed to address not only the immediate problems of late trading and market timing abuses, but represent a reevaluation of the Commission's oversight of the mutual fund industry as a whole. Most importantly, they put the needs of mutual fund investors first. I appreciate the opportunity to share with you my views, and I would be happy to answer any questions you may have.

PREPARED STATEMENT OF MATTHEW P. FINK

PRESIDENT, INVESTMENT COMPANY INSTITUTE

NOVEMBER 18, 2003

Introduction

My name is Matthew P. Fink. I am President of the Investment Company Institute, the national association of the American investment company industry. The Institute's membership includes 8,664 open-end investment companies (mutual funds), 601 closed-end investment companies, 106 exchange-traded funds, and 6 sponsors of unit investment trusts. The Institute's mutual fund members have assets of about $6.967 trillion, accounting for approximately 95 percent of total industry assets, and 90.2 million individual shareholders.

I appreciate the opportunity to appear before the Subcommittee today to discuss the issues of late trading and market timing of mutual funds, and the industry's commitment to take whatever steps are necessary to make sure that the interests of fund shareholders are fully protected.

The bedrock principle of the mutual fund industry is that the interests of mutual fund investors always come first. Consequently, the industry has reacted with shock and outrage to the allegations of late trading and market timing in the New York Attorney General's complaint in the Canary case [1] and other recent allegations of abusive mutual fund trading practices. There can be no excuse for knowingly permitting the buying and selling of fund shares at old prices after the market has closed. And while restricting market timing may be easier said than done, silently selling to a select few the right to trade fund shares is deeply troubling. Even more abhorrent is the notion that, in some instances, fund insiders themselves may have engaged in market timing to reap personal benefits at the expense of other fund shareholders. The industry commends the New York Attorney General's office and the Securities and Exchange Commission for their investigative efforts and forceful responses to these alleged practices. It is imperative that the ongoing investigations by the SEC and others of these allegations are thorough and successful in rooting out trading activities that have compromised or harmed the interests of individual mutual fund shareholders.

We cannot wait until those investigations are complete, however, to take the steps necessary to restore and to reinforce investor confidence in mutual funds. Investor confidence is every mutual fund's most precious asset. The industry earned the confidence of millions of Americans by serving their interests above all other considerations. Unfortunately, the business practices that have been alleged are inconsistent with this principle and are intolerable if mutual funds are to serve individual investors as effectively in the future as they have in the past. Forceful action will be the key to restoring and reinforcing investor confidence. The broad elements of what must be done to reassure investors are as follows:

- First, Government officials must identify everyone who violated the law. Forceful and unambiguous sanctions must be delivered swiftly wherever punishment is warranted.
- Second, if shareholders were harmed because of illegal or deceptive business arrangements, these wrongs must be made right.
- Third, any gaps in the otherwise strict system of mutual fund regulation must be identified and effectively addressed.

With respect to the last point, SEC Chairman Donaldson has announced plans to propose tough new regulatory requirements addressing the late trading and abusive short-term trading of mutual fund shares.[2] The SEC also will consider whether additional requirements are necessary to address the issue of selective disclosure of portfolio holdings information. The industry pledges its full support of the SEC in whatever course of action it determines will best protect mutual fund shareholders.

To help advance this objective, the Institute's Board of Governors established two separate task forces to identify specific options to address the issues of late trading and abusive short-term trading involving mutual fund shares. Based on the findings of the task forces, the Institute has developed several recommendations, which are outlined below.

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[1] *State of New York* v. *Canary Capital Partners, LLC, Canary Investment Management, LLC, Canary Capital Partners, Ltd., and Edward J. Stern* (NY S. Ct. filed September 3, 2003) (undocketed complaint) (Canary Complaint).

[2] *See* SEC Chairman Donaldson Releases Statement Regarding Initiatives to Combat Late Trading and Market Timing of Mutual Funds, SEC Press Release No. 2003–136 (October 9, 2003) (Donaldson Statement).

Mutual funds themselves also have acted swiftly to determine whether wrongdoing occurred in their firms. They have initiated internal investigations, in some cases aided by independent outside experts to investigate and judge the findings, and communicated their findings and responses to their boards and shareholders. In addition, some fund boards have retained independent third parties to conduct investigations. As a result of these investigations, several funds have terminated senior executives. Many funds have committed to taking remedial actions, including compensating fund shareholders for any detrimental impact that improper or illegal transactions may have had on their investments. These actions reinforce that funds take very seriously their obligations under the Federal securities laws and the fulfillment of their responsibility to make sure investors' interests always come first.

The remainder of my testimony will focus on the issues of late trading and abusive short-term trading of mutual fund shares. I also will discuss the practice of selectively disclosing information about fund portfolio holdings to shareholders, and oversight of hedge funds. Finally, I will discuss other initiatives to reinforce the protection and confidence of mutual fund investors.

Late Trading

A basic tenet of mutual fund investing is the concept of "forward pricing." Mutual funds are required to price their shares at least once each day, at a time or times designated by the fund's board of directors and disclosed in the fund's prospectus. Most funds price their shares as of 4 p.m. Eastern time, the close of regular trading on the New York Stock Exchange. All purchase and redemption orders received by a fund or its agents before 4 p.m. must receive that day's price. All orders received after 4 p.m. must receive the next day's price. The requirement that a purchase or redemption order be priced based on the fund's net asset value (NAV) next computed after receipt of the order is known as the "forward pricing" rule. The SEC adopted this rule in 1968 because it recognized that "backward pricing" (purchases and sales of fund shares at a previously determined NAV) could lead to dilution of the value of fund shares and could be susceptible to abuse in that it could allow speculators to take advantage of fluctuations in the prices of the fund's portfolio securities that occurred after the fund calculated its NAV.[3] Unfortunately, the recent allegations of late trading appear to bear this out.

Under current SEC rules and staff interpretations, funds may treat the time of receipt of an investor's order by a person designated by the fund (such as a dealer) as the relevant time for determining which price the order will receive.[4] Thus, it is common industry practice for intermediaries such as broker-dealers, banks, and retirement plan administrators to transmit their clients' purchase and redemption orders that were accepted before 4 p.m. to a fund for processing after 4 p.m. at that day's price.

Given the alleged abuses that recently have come to light, the Institute believes that existing regulations should be tightened to better protect against the possibility of late trading. The most effective solution to this problem would be to require that all purchase and redemption orders be received by a fund (or its transfer agent) before the time of pricing (that is, 4 p.m. Eastern time).[5] While such a requirement could have a significant impact on the many investors who own mutual funds through financial intermediaries,[6] the recent abuses indicate that the strongest possible measures are necessary to ensure investor protection. A 4 p.m. cut-off time at the fund would significantly limit opportunities for late trading by narrowing the universe of entities responsible for applying a 4 p.m. cut-off time to include only the funds and their transfer agents. In addition to limiting the number of entities involved, it would restrict them to SEC-regulated entities. This would simplify both funds' compliance oversight responsibilities and regulators' examination and en-

[3] *See* Investment Company Act Release No. 5519 (October 16, 1968).

[4] *See, e.g.,* Investment Company Act Release No. 5569 (December 27, 1968).

[5] As noted above, most funds price their shares as of 4 p.m. Eastern time. Thus, for simplicity, the discussion below assumes that this is the case. A fund that prices its shares as of a different time should be required to cut off orders by that time.

[6] Institute data show that the vast majority (approximately 85–90 percent) of mutual fund purchases are made through such intermediaries, including both the financial advisers and employer-sponsored retirement plans. *See* Investment Company Institute, 2003 Mutual Fund Fact Book, at 38. A 4 p.m. cut-off time at the fund will require intermediaries to apply an earlier cut-off time to the mutual fund orders they receive. This, in turn, will compress the time period during which investors conducting fund transactions through intermediaries could receive same-day prices. The precise impact likely will vary among different types of intermediaries, and among individual firms. In many cases, investors may no longer have the ability to obtain same-day prices.

forcement efforts with respect to potential late trading. In doing so, it would likely enhance compliance.

We note that Chairman Donaldson has specifically asked the SEC staff to examine the feasibility of such a requirement.[7] The Institute believes that applying order cut-off requirements to funds and their transfer agents is the best way to address late trading abuses at this time.[8] We urge the SEC to proceed expeditiously to adopt this approach.[9]

Market Timing

The ongoing investigations by the SEC and other governmental officials also involve issues relating to "market timing" of mutual funds. It is important to note that "market timing" is not a precisely defined term. Generally speaking, the term refers to a trading strategy involving frequent purchases and sales of mutual funds in an effort to anticipate changes in market prices. There is nothing inherently illegal or improper about such activity.

At some level, however, frequent trading activity can be disruptive to the management of a fund's portfolio. For example, frequent trading may compel portfolio managers either to hold excess cash or to sell holdings at inopportune times in order to meet redemptions. This can adversely impact a fund's performance, and increase trading and administrative costs. For this reason, many fund groups have sought to employ a number of methods designed to limit short-term trading, such as imposing redemption fees, restricting exchange privileges, and/or limiting the number of trades within a specified period. Many funds disclose in their prospectus that they do not permit market timing or that they may take steps to discourage it.

Different types of funds are affected differently by short-term trading, and higher turnover of smaller accounts has little effect on portfolio management. Funds also may seek to serve different types of investors; some funds are designed specifically to accommodate short-term trading. Thus, there is no "one size fits all" solution with respect to market timing generally.

The specific concerns that have been raised about market timing are not that funds did, or did not, have certain policies in place. Rather, it has been alleged that some funds were not applying their market timing policies fairly and consistently. A number of different steps can be taken to address these concerns, which are discussed below.

WRITTEN POLICIES AND PROCEDURES

SEC Chairman Donaldson has outlined various regulatory measures that the SEC staff is considering to address the alleged practice of certain funds allowing a few investors to engage in market timing activities in a manner inconsistent with their policies.[10] These measures include new rules and form amendments to: (1) require explicit disclosure in fund offering documents of market timing policies and procedures and (2) require funds to have procedures to comply with representations regarding market timing policies and procedures. The industry fully supports these measures.

While many funds already have market timing policies and procedures, requiring funds to adopt formal and detailed policies and procedures in this area will ensure that all funds have systems in place to address abusive activity. Such a requirement should also provide a more effective mechanism for boards and regulators to police compliance because more formal policies likely would limit discretion in dealing with short-term traders.

Another element of Chairman Donaldson's regulatory action plan is to reinforce the obligation of fund directors to consider the adequacy and effectiveness of fund market timing policies and procedures.[11] For example, fund boards could be required to receive regular reports on how these programs have been implemented. We strongly support reinforcing board oversight in this area.

Fund shareholders also will benefit from additional prospectus disclosure about a fund's policies on short-term trading by gaining an understanding of how the fund will protect their interests from abusive activity. Requiring that such disclosure be in a fund's prospectus could serve to enhance compliance with the policies. The dis-

[7] Donaldson Statement, *supra* note 2.

[8] In the future, advances in technology may make it possible to devise systems (*e.g.,* a system for "time stamping" mutual fund orders in a way that cannot be altered) that provide a high level of assurance regarding the time of receipt of an order by an intermediary. Nothing would prevent the SEC from revisiting this issue in that event.

[9] We note that a reasonable period of time will be needed to allow all affected entities to make the necessary systems changes to implement new cut-off requirements.

[10] Donaldson Statement, *supra* note 2.

[11] *Id.*

closure also could have a deterrent effect by alerting potential abusers to the fund's policies.

Additional steps are needed to address alleged abusive market timing activity by fund insiders. As noted above, this conduct, if true, is especially reprehensible. Thus, with respect to personal trading in fund shares by portfolio managers or a fund's senior executives, the Institute is urging all mutual funds to clarify or amend their codes of ethics to require oversight of personal trading activity by these persons in any funds offered or sponsored by the company.

FAIR VALUATION

An issue related to market timing is the obligation of funds to determine the fair value of their portfolio securities under certain circumstances. Much short-term trading activity appears to be motivated by a desire to take advantage of fund share prices that are based on closing market prices established some time before a fund's net asset value is set. It has been suggested that one way to address this concern is to require funds to fair value their portfolio securities more often. As part of Chairman Donaldson's regulatory action plan, the SEC staff is considering rules that would "emphasize the obligation of funds to fair value their securities under certain circumstances to minimize market timing arbitrage opportunities." [12]

The Investment Company Act establishes standards for how mutual funds must value their holdings. Funds are required to use market prices when they are available. This relies on the fact that market prices generally are objective and accurate reflections of a security's value. When market prices are not available, funds must establish a "fair value" for the securities they hold. The Investment Company Act places primary responsibility for fair valuation on a fund's board of directors. There is no definition of "fair value" provided in the Act, nor an established or required uniform method for fair value pricing inasmuch as it necessarily calls for professional judgment and flexibility.

In 2001, the SEC staff issued guidance that, among other things, discussed situations in which funds might need to utilize fair value pricing of foreign securities, even where those securities had closing prices in their home markets. In particular, the SEC staff said that, in certain circumstances, a significant fluctuation in the United States market (or a foreign market) may require a fund to fair value those securities.[13]

The rationale underlying the SEC staff's position is the same as that underlying the forward pricing rule discussed earlier in my testimony. To the extent that prices of foreign securities are correlated with changes in the U.S. market, a significant change in the U.S. market that occurs after the time that a foreign market closes can indicate that the closing prices on the foreign market are no longer an accurate measure of the value of those foreign securities at the time the U.S. market closes (*i.e.,* 4 p.m. Eastern time). Certain investors may attempt to exploit this situation by engaging in market timing activity. For example, a market timer might purchase shares of an international fund on days when the U.S. market is up significantly, and redeem shares of such a fund on days when the U.S. market is down significantly. Like late trading activity, this can hurt other shareholders in the fund by diluting their interests.

Unfortunately, knowing when and how to fair value foreign securities in these types of circumstances is not an exact science, as there is no way to know for sure at what price those securities would be traded as of 4 p.m. Eastern time. Consequently, funds must exercise their best judgment in valuing these securities. In designing procedures to determine fair value, funds must take care not to introduce too much subjectivity into the valuation process. On the other hand, if fair value procedures do not provide for sufficient (and frequent enough) adjustments, then they run the risk of losing their effectiveness in protecting fund shareholders from losses due to activity of the type described above.[14]

In order to appropriately balance these concerns, funds must have in place rigorous, board-approved policies and procedures concerning fair valuation. Some fund groups have developed detailed fair value pricing methodologies in-house; others are utilizing third-party service providers to assist them in valuing foreign and other securities. Either way, fair value policies and procedures can, and should, be updated as needed; as the 2001 SEC staff letter states, "Funds should regularly evaluate whether their pricing methodologies continue to result in values that they might

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[12] *Id.*

[13] Letter to Craig S. Tyle, General Counsel, Investment Company Institute, from Douglas Scheidt, Associate Director and Chief Counsel, Division of Investment Management, U.S. Securities and Exchange Commission, dated April 30, 2001 (2001 Valuation Letter).

[14] The potential for these losses can be mitigated by imposing restrictions on market timing.

reasonably expect to receive upon a current sale."[15] The ICI has published two compliance papers for its members on valuation issues, which are intended to assist them in meeting their regulatory responsibilities and in ensuring that fund share prices are fair to purchasing, redeeming, and existing shareholders.[16]

It is important to note that, while fair valuation can reduce the impact of harmful market timing activity, it cannot by itself completely eliminate such trading. Accordingly, as mentioned previously and as discussed further below, funds often employ additional methods to deter market timing activity.

TOOLS TO DETER MARKET TIMING

The investigations referred to above involved situations where funds allegedly granted exceptions from, or did not enforce, policies against market timing. It is important to note that many funds that are susceptible to market timing have devoted significant resources to efforts to combat such activity. Frequently, however, the various means that funds have employed to deter harmful market timing activity have not proved effective. Funds and their shareholders would benefit if funds had additional "tools" to restrict trading activity that they determine to be harmful to their shareholders. Last year, the SEC staff responded favorably to an Institute request to permit funds to delay exchange transactions, in an effort to deter some market timing activity.[17] There are additional methods for combating market timers that the SEC staff should consider permitting funds to employ. One such method would be to permit funds to impose a redemption fee (which is a fee paid directly to the fund to offset the costs resulting from short-term trading) greater than the 2 percent limit currently imposed by the staff.

A particular challenge that funds face in effectively implementing restrictions on short-term trading is that many fund investments are held in omnibus accounts maintained by an intermediary (*e.g.,* a broker-dealer or a retirement plan recordkeeper). Often in those cases, the fund cannot monitor trading activity by individual investors in these accounts. The Canary Complaint describes this practice as follows: "Timers . . . trade through brokers or other intermediaries . . . who process large numbers of mutual fund trades every day through omnibus accounts where trades are submitted to mutual fund companies *en masse.* The timer hopes that his activity will not be noticed among the 'noise' of the omnibus account."[18]

Steps clearly need to be taken to enable mutual funds to better enforce restrictions they establish on short-term trading when such trading takes place through omnibus accounts. One possible approach would be to require intermediaries to provide information about trading activity in individual accounts to funds upon request. Another approach would be to require most types of funds, at a minimum, to impose a 2 percent redemption fee on any redemption of fund shares within 5 days of purchasing them. If funds had a standardized minimum redemption fee along these lines, it should be easier for intermediaries to establish and maintain the requisite systems to enforce payment of those fees.[19]

We look forward to working with the SEC and with other regulators and industry groups on these matters.

Selective Disclosure of Portfolio Holdings

The SEC and other regulators are investigating allegations concerning the selective release by funds of their portfolio holdings to some but not all of a fund's shareholders. In particular, it has been alleged that some funds may have provided information about their portfolio holdings to certain shareholders in order to enable them to trade ahead of the fund, to the potential detriment of the other shareholders. Such conduct, if true, is deplorable. The industry is committed to working with the SEC to determine the best approach to deal with this matter.

One possible way to address this issue would be to require funds to adopt formal written policies in this area. The SEC could require that the policies be approved by the fund's board and that reports of instances when the information was released be provided to the board on a regular basis. In addition, funds could be required

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[15] 2001 Valuation Letter, *supra* note 13, at 7.

[16] *See* Investment Company Institute, *Valuation and Liquidity Issues for Mutual Funds* (February 1997) and Investment Company Institute, *Valuation and Liquidity Issues for Mutual Funds, 2002 Supplement* (March 2002).

[17] Investment Company Institute, 2002 SEC No-Act. LEXIS 781 (November 13, 2003).

[18] Canary Complaint, *supra* note 1, at par. 46.

[19] Funds should retain the flexibility to impose more stringent redemption fee standards, either in the form of higher redemption fees or longer minimum holding periods. As noted above, different types of funds are affected differently by short-term trading; hence, flexibility remains important. In addition, certain types of funds (*e.g.,* money market funds and funds that are designed specifically for short-term trading) should not be required to assess redemption fees.

to publicly disclose their policies for releasing portfolio information. This approach would have many benefits. Similar to market timing, requiring funds to adopt formal policies would ensure that they have a system to prevent disclosure that is not in the best interests of shareholders and to police compliance. Board oversight and public disclosure would further enhance compliance with the policies. At the same time, this approach would preserve some flexibility in how funds release information. This is very important because many funds release portfolio information for purposes that benefit investors. For example, they may provide it to independent services that analyze mutual funds and to certain intermediaries that provide professional assistance to help investors make decisions such as which funds to invest in and how to allocate their assets among investments.

Hedge Fund Oversight

The action brought by the New York Attorney General against Canary Capital also underscores the need for SEC oversight of hedge fund advisers. Currently, the Commission generally has access to records of trading on behalf of hedge funds through the records maintained by the brokers that the hedge fund advisers use and the markets on which they trade. The records, however, are dispersed and it is difficult to detect improper trading activities conducted by a particular hedge fund if such activities were effected through orders placed with multiple brokers and traded on multiple markets. The SEC recently issued a staff report on hedge funds [20] that included a recommendation to require hedge fund advisers to register under the Investment Advisers Act of 1940. The Institute supports this recommendation. As the Staff Report indicates, by requiring hedge fund advisers to register, the Commission would be able to more comprehensively and effectively observe the trading activities of the funds managed by such advisers. As a result, the Commission would be in a better position to detect improper or illegal trading practices.[21]

Other Initiatives

While the regulators have been actively involved in investigating and bringing enforcement actions relating to abusive mutual fund trading practices, as well as considering new regulatory requirements to prevent such practices in the future, it bears noting that these efforts are not the only current regulatory initiatives on behalf of fund investors. Other regulatory reforms, as well as voluntary industry actions, that are underway or have recently been completed also form an important part of overall efforts to reinforce the protection and the confidence of mutual fund investors. Current initiatives include the following:

Fund Compliance Programs

In February, the SEC proposed a rule to require mutual funds to have compliance programs.[22] Generally speaking, the proposal would require: (1) written compliance policies and procedures, (2) identification of persons responsible for administering the policies and procedures, (3) regular review of the policies and procedures, and (4) board oversight of funds' compliance programs. Requirements along these lines could provide an effective way to enhance protections against late trading, abusive short-term trading, and selective disclosure. The Institute generally supports this proposal.[23]

Mutual Fund Advertisements

The SEC recently adopted amendments to the mutual fund advertising rules to require enhanced disclosure in fund advertisements, particularly advertisements containing performance information.[24] Under the new rules, fund performance advertisements will have to provide a toll-free or collect telephone number or a website where an investor may obtain more current performance information (current as of the most recent month-end). In addition, fund advertisements will be required to advise investors to consider the investment objectives, risks, and charges and expenses of the fund carefully before investing and that this and other information about the fund can be found in the fund's prospectus.

[20] Staff Report to the U.S. Securities and Exchange Commission, *Implications of the Growth of Hedge Funds* (September 2003) (Staff Report).

[21] *Id.* at 92–95.

[22] *See* Investment Company Act Release No. 25925 (February 5, 2003).

[23] *See* Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Mr. Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission, dated April 17, 2003. In our letter we suggested certain modifications to ensure that the proposed requirement accommodates existing, effective compliance structures.

[24] *See* Investment Company Act Release No. 26195 (September 29, 2003).

Portfolio Holdings and Expense Disclosure

The SEC is expected to adopt soon a proposal that would require funds to disclose their portfolio holdings on a quarterly (rather than semi-annual) basis, and that would improve disclosure in fund shareholder reports.[25] As part of this proposal, funds would be required to disclose in their shareholder reports the dollar amount of expenses paid on a $10,000 investment in the fund during the period covered by the report. This disclosure, which would supplement the detailed fee disclosure currently required in fund prospectuses, would serve to remind investors about the impact of fund expenses and assist them in comparing the expenses of different funds. The Institute supports this proposal.

Sales Charge Breakpoints

Many mutual funds that are sold with front-end sales charges offer discounts to investors who invest specified amounts of money. The investment levels at which investors qualify for the discounts are called "breakpoints." In late 2002 and early 2003, regulatory investigations revealed instances in which investors did not receive the benefit of sales charge reductions to which they were entitled. Most of these situations did not appear to involve intentional misconduct. These examination findings led to the formation of a Joint Industry/NASD Breakpoint Task Force, made up of high-level NASD, mutual fund and broker-dealer representatives. The Joint Industry/NASD Breakpoint Task Force recently issued a report making a series of recommendations designed to ensure that processes are in place to ensure that investors receive applicable discounts.[26] The recommendations include additional required disclosure concerning breakpoint discounts. The Institute is working with its members, other securities industry participants and regulators on the implementation of the Breakpoint Task Force's recommendations and is committed to resolving the problems that have been identified for the benefit of mutual fund investors.

Revenue Sharing Arrangements

"Revenue sharing" arrangements involve payments by a fund's investment adviser or principal underwriter out of its own resources to compensate intermediaries who sell fund shares. The principal investor protection concern raised by these payments is whether they have the potential for influencing the recommendations of the financial intermediary that is receiving them. Disclosure concerning revenue sharing payments is already required in fund prospectuses, and the Institute has long advocated additional, point-of-sale disclosure by broker-dealers to help investors assess and evaluate recommendations to purchase fund shares.[27] The NASD recently proposed new point-of-sale disclosure requirements in this area.[28] The NASD proposal also addresses differential cash compensation arrangements, in which a broker-dealer firm pays its registered representatives different rates of compensation for selling different funds. The Institute supports the NASD proposal.[29]

Fund Governance

The recent disturbing revelations have caused some to question the effectiveness of the fund governance system. We do not believe it is fair to place blame upon directors, or the fund governance system. Directors cannot be expected to unearth every instance of wrongdoing, especially if such wrongdoing took place at an unrelated entity. At the same time, it seems apparent that steps need to be taken to enhance the ability of directors to exercise their oversight responsibilities, and some of those steps are discussed above.

Overall, we continue to believe that the system of mutual fund corporate governance has served investors very well through the years. It has even served as a model for reforming the governance of corporate America. In recent years the fund governance system has undergone several enhancements. For example, in June 1999, an Institute advisory group composed of investment company independent and management directors recommended a series of 15 best practices—that went beyond legal and regulatory requirements—to enhance the independence and effectiveness of investment company directors.[30] Subsequently, the SEC adopted rule amendments designed to further strengthen the independence and effectiveness of invest-

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[25] *See* Investment Company Act Release No. 25870 (December 18, 2002).

[26] Report of the Joint NASD/Industry Task Force on Breakpoints (July 2003).

[27] *See, e.g.,* Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Ms. Joan Conley, Office of the Corporate Secretary, NASD Regulation, Inc., dated October 15, 1997.

[28] NASD Notice to Members 03–54 (September 2003).

[29] *See* Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Barbara Z. Sweeney, NASD, Office of the Corporate Secretary, dated October 17, 2003.

[30] Report of the Advisory Group on Best Practices for Fund Directors (June 24, 1999) (Best Practices Report).

ment company directors.[31] Last month, at the behest of the Institute's Executive Committee, the Institute's Board of Governors adopted a resolution recommending that Institute member companies adopt additional best practices with respect to: (1) the treatment of close family members of persons associated with a fund or certain affiliates as independent directors and (2) the standards for investment company audit committees. The resolution also recommended that Institute members, to the extent they have not already done so, adopt the best practices set forth in the 1999 Best Practices Report.

Conclusion

The alleged abusive late trading and market timing activities recently uncovered by the New York Attorney General and the SEC are deplorable. Swift and forceful responses are necessary to make clear that there is no place in the mutual fund industry for those who would put their own interests before those of fund shareholders. The industry pledges its commitment to take any steps necessary to make sure that its obligation to place the interests of fund shareholders above all others is understood and fulfilled.

PREPARED STATEMENT OF MARC E. LACKRITZ

PRESIDENT, SECURITIES INDUSTRY ASSOCIATION

NOVEMBER 18, 2003

Introduction

Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee, I am Marc E. Lackritz, President of the Securities Industry Association.[1] I appreciate the opportunity to testify before the Committee today on a number of issues relating to the integrity of the mutual fund industry, as well as the broker-dealers that I represent.

The securities industry is based on two bedrock principles—disclosure and competition. But the public's trust and confidence are the indispensable elements for the capital markets to play their effective roles in channeling capital to its most productive uses. Our industry has raised more than $21 trillion over the past 10 years to finance innovation and growth—new enterprises, new processes, new products, bridges, hospitals, roads, and schools. Without public trust and confidence, our market mechanisms cannot function effectively or efficiently. Our system has thrived because all market participants must adhere to the same rules, vigorously and fairly applied.

Mutual funds are the vehicle by which an overwhelming majority of investors participate in our markets. They offer many small investors an inexpensive way to share in the benefits of owning stocks and bonds. Mutual fund portfolios give investors an avenue for diversifying a relatively minimal investment, thereby managing their risk exposures. For these reasons, mutual funds are extremely popular products for small investors, as well as for retirement plans such as 401(k) plans. As of January 2002, 89 percent of U.S. equity investors owned stock mutual funds, and 51.5 percent of equity investors held only stock mutual funds. Overall, 49.6 percent of all households in the United States owned mutual funds directly or through a retirement account.[2] Twenty-six percent of all household liquid financial assets were in mutual funds as of mid-year 2003.[3]

Broker-dealers and other intermediaries play a critical role in the distribution of mutual funds. Third-party financial professionals such as full service broker-dealers, financial planners, banks and insurance companies distribute approximately 55 percent of mutual fund assets. "Mutual fund supermarkets," generally operated by dis-

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[31] SEC Release No. IC–24816 (January 2, 2001).

[1] The Securities Industry Association, established in 1972 through the merger of the Association of Stock Exchange Firms and the Investment Bankers Association, brings together the shared interests of more than 600 securities firms to accomplish common goals. SIA member-firms (including investment banks, broker-dealers, and mutual fund companies) are active in all United States and foreign markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs nearly 800,000 individuals. Industry personnel manage the accounts of nearly 93 million investors directly and indirectly through corporate, thrift, and pension plans. In 2002, the industry generated $222 billion in domestic revenue and $356 billion in global revenues. (More information about SIA is available on its home page: *www.sia.com.*)

[2] Investment Company Institute, 2003 Fact Book, at 42–43.

[3] *www.sia.com/research/html/key*__industry__trends__.html#securities.

count brokers, distribute another 5 percent of mutual fund assets.[4] Full-service and discount brokers benefit investors and promote competition among funds by offering investors a convenient and accessible way to compare and to select from a range of different mutual fund families.

The health of our markets depends to a great extent on the public's continued robust participation in mutual funds. In 2002, equity mutual funds had a market capitalization of $2.7 **trillion** dollars, roughly 22 percent of the total capitalization of our equity markets.[5] Retail investors, the backbone of both the mutual fund industry and our securities markets, put their trust in the integrity of mutual fund managers and advisers, as well as in the financial advisers who assist their investment decisions and the brokers who implement their trade orders. The interests of retail investors must come first if we want them to continue entrusting their money to mutual funds. Investors must be assured that fraud, self-dealing, or dishonesty will not be tolerated. All investors should be treated fairly, and all aspects of the mutual fund business—including fund fee structures, financial incentives offered to intermediaries to recommend specific funds, fund investment and redemption policies, and fund governance—must be as transparent as possible. In addition, all investors should be assured of reasonably prompt execution and fair pricing of their mutual fund transactions.

In the past several months, State and Federal regulators have uncovered a number of instances of distressing behavior by some mutual funds and intermediaries. These include: (1) late trading or market timing in contravention of stated fund policies; (2) lack of full disclosure; and, (3) operational shortcomings relating to breakpoints. All of these instances share a common element: They hurt investors.

In the remainder of this testimony, I will discuss each of these disturbing revelations and the measures that we strongly support to resolve these problems and to earn back the public's trust and confidence. Each of these issues must be addressed swiftly and comprehensively by tough enforcement action where wrongdoing has occurred, thoughtful regulatory revisions to make sure that these problems cannot recur, and legislation to fill in existing "gaps" in the law. At the same time, it is equally important that regulatory or legislative solutions do not create new problems or other unintended consequences for investors in the course of remedying existing ones.

Late Trading/Market Timing

PROPOSALS TO ADDRESS LATE TRADING

Governing Principles

SIA is greatly distressed by the number of instances of mutual fund late trading. We believe that stringent enforcement actions to ferret out and punish such illegal activity will have a strong deterrent effect. We agree with the Securities and Exchange Commission Chairman Donaldson, however, that additional regulatory action needs to be taken to eliminate opportunities for such activity in the future. Investors will not accept the *status quo* and mere promises to do better. New rules must be put in place that do right by investors and ensure that these abuses will never happen again.

Appropriate regulatory action should meet several key principles. The rules should:

- Be reliable and "bulletproof" to new forms of evasion.
- Give investors the widest array of opportunities.
- Treat all investors—large and small; institutional and retail—equally.
- Synchronize new mandates with the complexities of existing and well-proven operational systems that investors count on to seamlessly clear and settle many millions of transactions per day.

Proposals for Reform

Several proposals have been advanced to address late trading by establishing a "hard close" for open-end mutual fund purchase or redemption order acceptance no later than the New York Stock Exchange's 4 p.m. ET close of business. Each of these proposals is intended to ensure that no transactions accepted after that point in time can receive the fund's pricing for that day. The key difference among the proposals is where they prescribe the "hard close." One approach would require that the mutual fund or its transfer agent must receive orders by 4 p.m. to receive same-

[4] Investment Company Institute, *www.ici.org/stats/res/per09–03.pdf,* at 5. By way of comparison, only 12 percent of purchases of mutual fund assets are made by individual investors directly from the fund.

[5] SIA 2003 Securities Industry Fact Book, at 47, 59.

day pricing. A second proposal has been circulated, but not finalized, under which orders received by the National Securities Clearing Corporation (NSCC), the centralized entity through which most mutual fund orders are cleared, would also satisfy the "hard close" requirement. Finally, a third approach would permit the hard close to occur at either the mutual fund, NSCC, or a broker-dealer or other SEC- or bank-regulated intermediary or other entity, so long as the order recipient has a verifiable order capture system.

As discussed below, we think that a hard close that can only occur at the mutual fund has some significant drawbacks for investors, and also may have some major operational difficulties. A hard close at NSCC may best meet concerns about a verifiable order entry deadline, while a hard close at the broker-dealer or other intermediary would be preferable from the vantage point of most retail investors and retirement plan participants. In any event, we must demonstrate to the public not only that late trading will be punished severely, but also that it will be foreclosed from ever happening again.

(i) *Hard Close at the Mutual Fund.* One early proposal to emerge in response to the revelations about late trading is a suggestion that the SEC require that only orders that are received by a mutual fund prior to 4 p.m. ET should receive that day's pricing. This proposal may be an effective way of foreclosing late trading. However, measured against the principles that we articulated above it has several significant shortcomings.

Most importantly, it would be likely to create a two-tiered market, in which institutional investors that clear their transactions directly with funds would have the ability to trade until 4 p.m. ET, while retail investors who generally hold their mutual funds through a broker-dealer or other intermediary, as well as administrators of many 401(k) and similar retirement plans that generally rely on intermediaries for processing participant orders would have to get in their orders by a much earlier cut-off time in order to complete all processing necessary to transmit orders to the fund by 4 p.m.[6]

Because of the multiple steps necessary to clear and settle mutual fund orders, in general investors would face a cut-off time approximately 2 hours prior to the 4 p.m. ET hard close at the fund, although the exact cut-off would vary from firm to firm. Individual fund investors that desire the service of broker-dealers or other intermediaries should not be prejudiced by an early cut-off while other fund investors would be free to trade for approximately 2 additional hours solely by virtue of their relationship with the fund.[7] This could be a substantial hardship. These investors would lose the ability to shape their investment decisions by observing market developments in the last two hours of the trading day.

A 4 p.m. ET hard close could pose an even more serious disadvantage for the 36 million families who invest through employer-sponsored retirement plans. Institutions that provide recordkeeping services to 401(k) plans would likely need to cut off order acceptance much earlier than broker-dealers.[8] In the case of the west coast participants, this could mean that trades would have to be placed in the early morning hours of the business day, and may only be able to receive next-day settlement. This would place retirement plan participants at a marked disadvantage to other institutions.

The durability of a hard close at the fund to attempts at evasion is also not clear. Unless it is accompanied by a requirement to use auditable technology to ensure that the order entry time at the fund is not subject to abuse, similar to what we

[6] Broker-dealers that self-clear, or that act as introducing brokers and clear their transactions through a third party, must process and batch these orders and perform breakpoint analysis on the orders before they are sent on to NSCC, which processes and clears the orders and transmits them to the fund company through its Fund/Serv facility. Other entities that receive mutual fund transactions from customers, such as banks, must perform similar steps prior to sending the orders to fund companies.

[7] Moving fund holdings from intermediaries to the funds themselves may not be a viable option for many retail investors because they would lose the array of choices of different fund complexes that a broker-dealer can offer, as well as special execution services, such as the ability to liquidate equity or debt securities to purchase fund shares (or vice versa) or to exchange shares of funds of different fund complexes.

[8] This is because the 401(k) system has additional complexities than those faced by broker-dealer recordkeeping systems. For example, 401(k) recordkeepers must place trades collectively, and perform a number of reconciliations at the participant and plan levels in executing transactions. In addition, recordkeepers perform other services that add time to the process such as determining eligibility for loans since Federal law regulates the amount of a loan based on a participant's account balance.

propose in connection with the hard close at the broker-dealer alternative, concerns about late trading may linger.[9]

This approach would also pose significant operational challenges. Currently, there is no need for real-time capture, routing and execution of fund orders, since fund pricing is only established once a day. Consequently, many firms extract such orders to batch and route to the fund or NSCC. To require that firms present mutual fund trades to the fund by 4 p.m. ET would result in many broker-dealers extracting a day's worth of orders and transmitting all of them to the fund near the 4 p.m. close. This could create a huge technology jam that funds may not be prepared to manage.

Funds may also not be prepared to manage other aspects of the clearing process that this approach may effectively shift onto them. For example, in today's world a broker-dealer might receive an order prior to 4 p.m., and after the 4 p.m. close send a fund, via NSCC, an order to sell a certain number of shares (or a certain dollar amount) of a fund, including a post-4 p.m. "enrichment" of the data by factoring the closing price into performing its breakpoint analysis and crediting the customer's account for the cash (or debit it for the shares). With a 4 p.m. hard close, the fund itself would have to perform this enrichment function with the closing price data. Funds are not currently set up to do this, and might seek to subcontract this work back to NSCC. Thus, operationally the "hard close at the fund" approach could start to closely resemble the "hard close at NSCC" proposal.

(ii) *Hard Close at NSCC.* We understand that NSCC (which operates the NSCC/Fund/Serv mutual fund processing system) is considering proposing the development of a centralized time stamp facility as an answer to concerns about late trading. That facility would enable intermediaries to transmit fund orders throughout the day to NSCC or batch them prior to 4 p.m., but still provide the opportunity to submit essential enrichment data which is necessary to complete the transaction after the close. Among other things, this data would include information related to breakpoint entitlement, calculation of contingent deferred sales loads, and exchanges between funds.

This approach, while still under discussion, is a very promising way to address the late trading issue as measured against our key principles. It should be possible to design this proposal so that it is reliable and resistant to evasion. This is particularly the case since NSCC, as a third-party processor with no relationship to the customer and only a very limited relationship with the intermediaries and funds, would have no motive to circumvent the order entry timing requirement. This proposal also builds directly on a well-tested and experienced clearing system. While it would certainly require expanding some technology and systems, it appears to pose a much less daunting operational challenge than a hard close at the fund.

The impact on investors would also not be as severe as under a hard close at the fund. However, the NSCC approach would still face some drawbacks on this score. Investors who transact mutual fund purchases and redemptions through broker-dealers and other intermediaries, and retirement plan administrators, would still have to get their trades in at some point before the 4 p.m. close in order to get the benefit of same-day pricing. We have not been able to determine how significant this gap would be, but it would certainly be a much smaller disparity than would be created by a requirement that would only permit same-day pricing for orders received by the fund by 4 p.m. ET.

(iii) *Hard Close at the Intermediary.* The third proposal, which SIA advanced in an October 31 letter to the SEC, would permit same-day pricing for orders received by the broker-dealer or other intermediary by 4 p.m., as well as orders received by the mutual fund or by its processing agent by 4 p.m. This would be subject to the qualification that the recipient of the order must have an electronic order capture system, with verifiable order entry time aligned with an atomic clock to document receipt. This requirement would eliminate a salesperson's ability to either withdraw a fund order after 4 p.m. or receive current day pricing for an order entering the system after 4 p.m.

This proposal is the most attractive of the three from the standpoint of investor fairness. Investors would receive same-day pricing under the same terms that they do today, regardless of whether they are institutional or retail, trading through a broker-dealer or other intermediary, or directly with a fund.

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[9] In a recent speech at SIA's Annual Meeting in Boca Raton, Florida, SEC Chairman Donaldson noted that 10 percent of funds, as well as 25 percent of broker-dealers, have been involved in enabling late trading by customers. Therefore, a verifiable order entry time stamp should be an essential element of any response to late trading that relies on when orders are received by a fund or an intermediary. Remarks of Chairman William H. Donaldson to the Securities Industry Association, November 7, 2003, *http://www.sec.gov/news/speech/spch110703whd.htm,* at 2–3 (Donaldson Boca speech).

For broker-dealers this approach is also workable as an operational matter. Broker-dealers are already required to use a verifiable order entry time stamp aligned with an atomic clock for processing equity transactions. Mutual funds and their processing agents, as well as banks and other intermediaries would need to build similar systems, but the technology and processes already exist.

Bank regulators such as the Office of the Comptroller of the Currency would need to impose a companion rule to require a hard close on order acceptance by 4 p.m. together with a required electronic capture system. For entities which are unregulated, or unable to comply with the hard close time stamping requirement or other comparable verification systems, orders would need to be placed with the fund directly, or some other designated regulated entity that has electronic time stamping capability to ensure receipt by the hard close cutoff time.

We are confident that this approach would not be subject to abuse. It would rely on the same electronic order audit system that the SEC and self-regulatory organizations required firms to adopt so that the regulators could monitor order-handling processes for equity securities. Components of the system should also include written policies and procedures to insure compliance, with senior management sign-off on the adequacy of those procedures, and an annual external audit to measure compliance with, and the effectiveness of, these procedures.

PROPOSALS TO ADDRESS MARKET TIMING

"Market timing" refers to a trading strategy in which an investor engages in frequent transactions in mutual funds in anticipation of changes in market prices. Usually this is done to try to profit from discrepancies between the time when an underlying asset is priced and the time when a fund's net asset value is set. A common example is a mutual fund investing exclusively in foreign securities traded in markets that close prior to U.S. markets, and which may be sensitive to changes in the U.S. market. A market timer may choose to buy or redeem fund securities, depending on whether the U.S. market is going up or down substantially on the day, in the hope that the opening price of the underlying asset will change as a result of the U.S. market move. The investor would receive an arbitrage profit on the lag between the pricing of the fund and of its underlying assets.

Market timing is not inherently illegal, but it can pose problems for many mutual funds. For example, market timing activity can drive up a fund's administrative costs as the fund manager must either sell assets or hold extra cash to meet redemption demands of market timers. It also has the potential to dilute the interests of other fund shareholders who do not engage in market timing. Because of these drawbacks, many funds have policies and procedures to discourage market timing.

Recent enforcement actions and press reports of ongoing investigations by Federal and State regulators appear to involve just such instances in which funds and intermediaries facilitated market-timing transactions despite statements in the fund prospectus that the fund would not assist such activities. As a result of these developments, a number of regulatory proposals have been advanced to address market-timing transactions. Here are two potentially useful steps:

- SEC Chairman Donaldson has proposed that rules regarding disclosure of fund policies and procedures on market timing should be tightened, and that funds should be required to have procedures to fully comply with any representations that they make concerning their market timing policies and procedures.[10]
- SIA has also proposed, subject to customer privacy rights, a requirement that sufficient trade-level customer detail be provided to funds to assist them in identifying market-timing activity on transactions that are submitted by the intermediary on an aggregated basis.

Both of these steps would do a great deal to deter market timing in contravention of fund policies. A further step would be to permit funds to impose a fee (of 2 percent or some other level) on any fund shares redeemed within 5 days of purchasing them. The proceeds of this fee would go to the fund for the benefit of the fund's long-term shareholders. As originally proposed, the only exceptions would be for money market funds, and for a fund that prominently discloses that it is designed for short-term trading and that secures a specific SEC exemption from the requirement.

[10] Additionally, in 2001, the SEC issued guidance suggesting that funds might have an obligation to apply methodologies to apply a fair value to fund assets in situations where changes in the U.S. market create a potential discrepancy between an international mutual fund's day-end net asset value and the overseas closing price of foreign securities that it holds. Letter to Craig S. Tyle, General Counsel, Investment Company Institute, from Douglas Scheidt, Associate Director and Chief Counsel, Division of Investment Management, U.S. Securities and Exchange Commission, April 30, 2001.

While we generally disfavor regulatory approaches that involve pricing regulation, the problems that have arisen are such that we support such a proposal. We think it will be a very effective step toward ending abusive market timing transactions. The only modification that we suggest is that the SEC provide a narrow exemption for hardship cases, so that an investor can make a single transaction without incurring the 2 percent fee if the investor can demonstrate in writing that the transaction is necessary to meet an unanticipated personal financial hardship.

In addition to these steps, the recent amendment to H.R. 2420 would require the SEC to adopt regulations to eliminate stale pricing, the underlying source of both late trading and abusive market timing. While the steps outlined above may be sufficient to address this issue, we believe that swift action on many fronts needs to be considered. Therefore, we not only support the 2 percent redemption fee, but also SEC action to address the overall issue of stale pricing.

We strongly support tough enforcement action against abusive market timing, as well as prompt implementation of regulatory reform. This will go a long way toward repairing the damage to public trust and confidence that revelations of abusive market timing have caused.

Disclosure Proposals

We favor clear, direct, timely disclosure of all material information to investors in a central place. It is really important to make it investor-accessible and investor-friendly rather than a "Where's Waldo?" search through fragments of disclosures for relevant information.

REVENUE SHARING AND DIFFERENTIAL COMPENSATION

We strongly support efforts to enhance the transparency of revenue sharing and differential compensation to mutual fund investors. At a minimum such enhanced disclosure should embody the following elements:

- A balanced presentation of the nature of services received (including the inclusion of funds on preferred or select lists, or provision of shelf space) and expenses reimbursed pursuant to revenue sharing arrangements.
- A listing of funds or of fund families with whom revenue sharing arrangements exist.
- The aggregate amount of revenue sharing payments received during a specified period.
- The funds or fund families with respect to which higher percentage rates of compensation are paid to associated persons.
- The extent, if any, to which associated persons may only recommend the purchase of funds with respect to which the broker-dealer participates in revenue sharing arrangements.

As you all know, a number of regulatory and legislative initiatives directed at improving transparency have emerged in recent months. These include H.R. 2420 introduced by Congressman Richard Baker (R–LA),[11] proposals made by Representatives Oxley and Baker in a letter to SEC Chairman Donaldson,[12] an NASD rule proposal regarding compensation for the sale of investment company securities[13] and testimony by SEC Chairman Donaldson on September 30, 2003, before the Senate Committee on Banking, Housing, and Urban Affairs, in which Chairman Donaldson stated that:

> I envision that a revised confirmation would include information about revenue sharing arrangements, incentives for selling in-house funds and other inducements for brokers to sell fund shares that may not be immediately transparent to fund investors. . . .

Meanwhile, as a by-product of the recommendation of the NASD Mutual Fund Breakpoint Task Force—in which SIA has been an active participant and which I will discuss in a moment—task force working groups are currently developing confirmation modifications and a new disclosure document prototype to enhance disclo-

[11] See H.R. 2420 mark-up dated July 24, 2003. H.R. 2420 focuses on additional customer statement disclosure or other nonprospectus disclosure. Proposals regarding revenue sharing and differential compensation appear in Section 12 of the bill.

[12] Letter to SEC Chairman Donaldson from Representative Michael Oxley (R–OH), Chairman, House Financial Services Committee and Representative Richard Baker (R–LA), Chairman Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises (July 30, 2003).

[13] NASD *Notice to Members* #03–54 (September 2003). The NASD proposal appears to require additional disclosure to be delivered in some manner other than by means of the confirmation, the customer statement, or prospectus.

sure of breakpoint information to customers. Each of these different initiatives has the potential to enhance the transmission of relevant information to mutual fund investors. However, when considered together, there appears to be a substantial risk of disclosure fragmentation and associated investor confusion, particularly if these initiatives proceed without coordination and consistency of treatment.

Therefore, in submissions we have made to the NASD[14] and SEC[15] we have urged that any rulemaking in this area be designed to:

- Achieve a uniform approach across regulatory entities regarding the disclosure mechanisms for information on revenue sharing and differential compensation arrangements.
- Focus disclosure on circumstances where such arrangements are likely to influence recommendations made to investors, or limit the scope of recommendations that may be offered.
- Utilize disclosure vehicles that will facilitate, rather than inhibit or deflect, investors' attention away from all material information that should be considered when making a mutual fund investment.

DISCLOSURE OF OPERATING EXPENSES

SIA fully believes that investors should have full, complete, and useful information on mutual fund fees since they can have a significant effect on an investor's return. We believe that the most efficient means for providing this information to investors is for funds to calculate expenses based on a hypothetical $1,000 investment. House Report 108–351 accompanying H.R. 2420 (November 4, 2003) notes at 11 that:

> The SEC recently proposed a new rule requiring disclosure in a fund's semi-annual and annual report to include: (1) a dollar example of the fees an investor would have paid on a hypothetical $10,000 investment, using the actual exposes incurred by the fund and the actual return achieved by the fund; and (2) the same dollar example using the actual expenses incurred but assuming a 5 percent return over the period so funds could be compared against each other. * * * H.R. 2420 generally codifies the pending SEC proposal, but includes two important changes: First, the dollar example in the annual report must be based on a hypothetical $1,000 investment. The Committee believes that using $1,000 as the example will make it easier for investors to calculate the amount of fees paid. Second, the legislation includes a requirement that account statements include a legend prominently stating that: (1) the investor has paid fees on the mutual fund investment, (2) those fees have been deducted from the amount shown on the statement, and (3) the investor can find more information by referring to documents disclosing the amounts of those fees.

SIA generally concurs with these provisions. Providing information on a $1,000 investment both with respect to that fund's return and with respect to a hypothetical 5 percent return will facilitate exactly the type of comparison-shopping that H.R. 2420 and the SEC contemplate. At the same time, the costs of these changes (which ultimately investors bear) will be in proportion to the benefit that investors derive.[16]

In addition, SIA appreciates the Report language noting that such disclosures should indicate that the customer's portfolio already reflects those charges and that they are not additional charges that the broker-dealer or fund will deduct. Absent such clarification, investors might be confused. SIA believes that any new disclosure should afford funds appropriate flexibility and ensure that fee disclosures do not receive disproportionate emphasis.

SIA also believes that this aspect of H.R. 2420 attempts to place an appropriate emphasis on mutual fund fees as part of the larger investment decision. As noted, fees can have an important effect on an investor's return. But fees are only one aspect of an investment decision. Investors (and their brokers, in the case of broker-

[14] Letter to Barbara Sweeney, NASD from Stuart R. Strachan, Chair, SIA Investment Company Committee "Rule Proposal Regarding Compensation for the Sale of Investment Company Securities" (October 17, 2003).

[15] Letter to Paul F. Roye, Director, SEC Division of Investment Management from Stuart R. Strachan, Chair, SIA Investment Company Committee, "Revenue Sharing and Differential Compensation" (October 31, 2003).

[16] *See* Memorandum from Paul F. Roye, Director, Division of Investment Management, SEC, to the Honorable William H. Donaldson, Chairman, SEC, June 9, 2003 at 13–18. *See also,* GAO, *Mutual Funds, Greater Transparency Needed in Disclosure to Investors,* June 2003 (GAO–03–763) at 11 *et seq.*

sold funds) need to consider not just expenses, but whether the investment is appropriate for the investor's situation.

SOFT DOLLARS, DIRECTED BROKERAGE, AND RELATED ISSUES

SIA supports efforts to improve disclosure of brokerage arrangements between funds, their advisers, and broker-dealers. When Congress enacted Section 28(e) of the Securities Exchange Act of 1934, it recognized the need for money managers to obtain research from a wide range of sources. Section 28(e) enables money managers to pay for research and related services through commission (soft) dollars rather than paying for them in cash. Such research helps money managers, including fund managers, do a better job of serving their customers. Over the years, the Commission has issued interpretations on the scope of research services that may be provided and examined industry practices.[17] The 1998 Report notes, "the vast majority of products and services received by advisers are within the safe harbor established by Section 28(e) of the Exchange Act."[18] In general, SIA has viewed soft dollars as both pro-investor and pro-competitive.

At the same time, we recognize that there are opportunities for abuse with respect to soft dollars. The 1998 Report documented problems and abuses of significant concern. SIA strongly supports SEC and SRO enforcement efforts to curb soft-dollar abuses and to deter others from engaging in such abuses. We also believe that mutual funds should ensure effective disclosure of soft-dollar practices both to investors and to fund trustees. Section 3 of H.R. 2420 is intended to address these concerns and we generally support those goals.

Directed brokerage also has been a subject of concern. The 1998 Report—in citing the 1986 Release—states that unlike soft dollars, directed brokerage does not present the same conflict of interest issues, since *"the fund's commission dollars [are used] to obtain services that directly and exclusively benefit the fund."*[19] In these situations the fund directs the money manager to execute a portion of the fund's trades through a particular broker-dealer. In return for the brokerage commissions the broker-dealer typically provides services directly to the fund or pays certain fund expenses.

We believe that with respect to both soft dollars and directed brokerage, a key investor protection issue is best execution. If fund investors received mediocre executions because of soft dollar or directed brokerage arrangements, the relationships are indefensible. Poor executions in the absence of soft-dollar or directed brokerage arrangements would be just as indefensible. In short, advisers, fund trustees, and broker-dealers must serve the needs of fund investors with respect to research and execution services.

SIA supports disclosure to investors and fund trustees to ensure that arrangements with broker-dealers are disclosed fairly and in context. Again, disproportionate emphasis on costs may confuse and distract investors or trustees from examining the investment and all relationships among service providers. Nonetheless, balanced disclosure of material information is essential if investors and the trustees acting on their behalf are going to make intelligent, informed decisions.

Breakpoints

OVERVIEW

Late in 2002, the SEC and the NASD became concerned that investors in mutual funds were not receiving "breakpoint" discounts, which are essentially volume discounts for purchases. The NASD indicates that "during routine examinations of broker-dealers by [the NASD's] Philadelphia District Office, the NASD discovered that broker-dealers selling front-end loaded mutual funds were not properly delivering breakpoint discounts to investors."[20] The regulators' concerns were first articulated in an NASD *Notice to Members* dated December 23, 2003, and a letter from the SEC to senior brokerage firm executives. SIA, along with the Investment Company Institute (ICI), cooperated fully with the SEC and the NASD in an effort to publicize regulators' concerns and to help ensure that broker-dealers and funds ad-

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[17] *E.g.,* Interpretive Release Concerning Scope of Section 28(e) of the Securities Exchange Act of 1934 and Related Matters, Rel. 34–23170 (April 23, 1986) (1986 Release) and Inspection Report on the Soft-Dollar Practices of Broker-Dealers, Investment Advisers, and Mutual Funds, September 22, 1998 (1998 Report).

[18] *Id* at 4.

[19] 1998 Report at 13 (emphasis added in 1998 Report, not in 1986 Release).

[20] Testimony of Mary Schapiro, NASD Vice Chairman and President Regulatory Policy and Oversight, Before the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, Committee on House Financial Services, November 3, 2003, at 4.

dressed the situation. For example, SIA subsequently urged its membership to review their breakpoint procedures and promptly take any necessary corrective action.

In March 2003, the SEC, the NASD, and the NYSE issued a report on breakpoint practices.[21] After examining 43 firms, the Report noted:

> Most of the firms examined, in some instances, did not provide customers with breakpoint discounts for which they appear to have been eligible. Overall, examiners identified a significant number of transactions that appeared to be eligible for a discount, though did not receive a discount or incur other unnecessary sales charges. Three firms did not provide a discount in all sampled transactions that appear to have been eligible for a discount, and two firms provided customers with all available discounts.

However, the Report also noted "many of the problems do not appear to be intentional failures to charge correct loads."

RECOMMENDATIONS

In response to a request from the SEC Chairman,[22] the NASD organized a Task Force to address breakpoint concerns. The SEC asked the SIA and ICI to co-chair the effort. The Task Force was composed of a broad cross-section of the financial industry, including representatives from the NASD, NYSE, NSCC, broker-dealers, mutual funds, and transfer agents. SEC staff attended the meetings as well. On July 22, 2003, the Task Force issued its report with the following recommendations:

(A) *Common Definitional Standards:* The mutual fund industry should adopt common definitions of terms frequently used in defining breakpoint opportunities.

(B) *Central Breakpoint Schedule and Linkage Database:* The mutual fund industry should create a central, comprehensive database of pricing methods, . . . breakpoint schedules, and the linkage rules used to determine when a breakpoint has been reached and should make that database easily accessible to broker-dealers' registered representatives. . . .

(C) *Mutual Fund Prospectus and Website Disclosure:* Mutual funds should provide the critical data regarding pricing methods, breakpoint schedules, and linkage rules in their prospectuses and on their websites, in a prominent and clear format.

(D) *Confirmation Disclosure:* Confirmations should reflect the entire percentage sales load charged to each front-end load mutual fund purchase transaction.

(E) *Standardized Checklists or Order Verifications:* As an initial matter, broker-dealers should require registered representatives to complete electronic or paper checklists or place notations on firm paper or electronic records.

(F) *Record of Linkage Information:* At the time an investor first purchases front-end load shares of a particular fund family, his broker-dealer should record the investor's linking information, preferably using a standardized worksheet.

(G) *Prospectus Disclosure Regarding Customer's Role in Assisting in Securing Breakpoint Discounts:* The SEC should mandate that a fund's prospectus disclose that investors may need to provide their broker-dealer with the information necessary to take full advantage of the breakpoint discounts.

(H) *Confirmation Breakpoint Legend:* Confirmations for purchases of front-end load mutual fund shares should include a disclosure legend that alerts customers that they may be eligible for breakpoint discounts and refers customers to the appropriate materials (that is, mutual fund prospectus or website) to determine breakpoint discount eligibility.

(I) *Written Disclosure Statement:* Broker-dealers should provide to each investor a disclosure statement at the time of or prior to the confirmation of his initial purchase of front-end load fund shares.

(J) *Registered Representative Training:* NYSE and NASD rules require broker-dealer registered personnel to undergo periodic training.

(K) *Investor Education:* The investing public should fully understand the availability of breakpoint discounts because there are particular instances, as cited above, in which investors must be active participants in assuring their receipt of an eligible breakpoint.

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[21] Staff Report: Joint SEC/NASD/NYSE Report of Examinations of Broker-Dealers Regarding Discounts on Front-End Sales Charges on Mutual Funds, *http://www.nasdr.com/pdf/-text/bp*_joint_exam.pdf.

[22] Letter from then-SEC Chairman Harvey Pitt to the NASD Chairman Robert Glauber dated January 15, 2003.

The Task Force has appointed working groups led by the NASD, the ICI, and the SIA to implement these goals. The Task Force met again on October 28, 2003, so that each working group could report on its activities. Briefly, the groups have made substantial progress in completing the effort, which will result in a better and more extensive flow of information to investors regarding breakpoint opportunities, an enhanced investor ability to determine whether they received the sales charge reductions to which they are entitled, improved systems for capturing and storing information regarding accounts entitled to be aggregated for breakpoint purposes, and improved communication of information between funds and broker-dealers regarding breakpoint policies.

While the development of standardized definitions of breakpoint terminology is very helpful, the wide variation in breakpoint policies across hundreds of fund families and thousands of funds still poses a daunting challenge. While we do not advocate a standardization of breakpoint policies, we do believe it appropriate for the regulators, the SIA and the ICI to continue to work together to explore ways in which breakpoint policies can be made easier to apply, so that the risk of any further operational problems regarding customers receiving the correct breakpoint is further reduced.

It is important to note that the SEC charged the Task Force with addressing breakpoint problems prospectively. The SEC and the self-regulators have been working with firms to ensure that mutual fund customers are made whole.[23]

Conclusion

Like many investors, regulators, and policymakers, we have been surprised and dismayed by the reports of abuses relating to the sale of mutual funds to investors. Although any report of malfeasance in the financial industry is one too many, these reports have been particularly upsetting because mutual funds are the investment vehicle of choice for many Americans. Reports of abuses in this aspect of the financial world have a particularly corrosive effect on public trust in the investing and capital raising process. At SIA's recent Annual Meeting, SEC Chairman William Donaldson said:

> I have spent many years in and around the securities industry, during which time I have seen that we have the world's most creative, and most industrious workforce. I have also seen that this industry is populated by fundamentally decent and honest people. Indeed, these traits provide the foundation of our economic vibrancy. The securities industry has found itself stuck in a legal and ethical quagmire, but I am confident that the industry will work together to pull the industry out of the muck and live up to a higher ethical standard. You can be sure that if you do not, those of us in Government will.[24]

We are fully committed to addressing these concerns thoroughly—by supporting vigorous enforcement of current rules and by supporting appropriate legislative and regulatory reforms. We and our member-firms will work with policymakers to ensure that mutual fund investors once again can have justifiable faith in these products and our markets. We look forward, Mr. Chairman, to working with you and the Committee to earn back the public's trust and confidence.

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[23] SIA understands that these efforts range from letters of caution from self-regulators to SEC notices of possible Enforcement action (so-called "Wells" notices). As a policy matter, generally SIA does not involve itself with enforcement matters.

[24] Donaldson/Boca Speech.

REVIEW OF CURRENT INVESTIGATIONS AND REGULATORY ACTIONS REGARDING THE MUTUAL FUND INDUSTRY

THURSDAY, NOVEMBER 20, 2003

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 2:14 p.m. in room SD–538 of the Dirksen Senate Office Building, Senator Richard C. Shelby (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN RICHARD C. SHELBY

Chairman SHELBY. The hearing will come to order.

On Tuesday, Chairman Donaldson provided an overview of the SEC's regulatory response to the abuses in mutual funds. This afternoon, we will hear from the State and Federal regulators who are on the front lines investigating trading abuses and other questionable practices in the mutual fund industry.

In late September, this Committee first discussed late trading and market timing activities with Chairman Donaldson. Since then, it has become apparent that revelations about late trading and market timing activities were just the beginning of the abuses that investigators would discover.

Following Attorney General Spitzer's initial settlement, regulators have opened investigations into multiple fund and brokerage practices. Regulators are now investigating funds that have selectively disclosed portfolio information to certain privileged investors and fund executives that may have engaged in illegal insider trading. Regulators are also investigating brokers who receive additional payments and commissions to favor certain funds without disclosing such incentives to their clients, sell more expensive fund shares to unsuspecting investors in order to generate high commissions, or fail to give clients breakpoint discounts on fund purchases.

It seems that a day does not pass when we do not read shocking new disclosures about fund executives and brokers neglecting their investors' interests and profiting at their expense. It seems as if each fund or brokerage house that is investigated has engaged in some level of misconduct, at least up to now.

The scope of the recent revelations is particularly troubling. One has to question whether this is the result of a few bad actors, or widespread industry practices. I hope that these revelations are not evidence of the industry standard, but I am very suspicious. Nevertheless, we will get to the bottom of this.

However, as a result of the SEC's recent examination survey, we have learned that a shockingly high number of funds and brokers have engaged in the practices now under investigation. For too long, these practices have not been disclosed to investors and were largely unchallenged. It is time, I believe, for the securities industry to realize that such practices cannot, and will not, be tolerated.

Vigorous enforcement is crucial to regaining investors' trust and restoring integrity to our markets and the fund industry. Investors must be assured that fund executives and brokers who violate their duties to investors will be punished. Vigorous investigations are also critical to this Committee as we consider any potential legislative reforms. It is vital that we understand the full scope of the transgressions, conflicts, and structural problems that are at the root of the misconduct in the fund industry. Such an understanding will only come as the regulators define the full scope of the problems confronting the industry.

The recent investigations into the fund industry demonstrate the benefits of a dual regulatory structure in which both State and Federal regulators protect the investors' interests. Regardless of who first initiated the probes, State and Federal regulators share the same goal of stopping misconduct and restoring investor confidence in the fund industry. Toward this end, Federal and State regulators have significant, yet distinct, roles to play as the investigations progress. State law enforcement and the SEC have different mandates and authorities, but should share a common goal—assuring the rule of law and a fair deal for the ordinary investor. I believe that it is incumbent upon the State and Federal regulators to find a way to coordinate their investigatory and enforcement efforts in a responsible and a professional manner that always puts the investor first. Successful State and Federal collaboration is essential to the comprehensive investigation of this $7 trillion mutual fund industry.

The duty to protect investors is a long-term responsibility. Inherent in this duty is a responsibility not only to make sure that the mutual fund industry operates in accordance with the highest standards, but also to avoid rush actions that could cause unnecessary damage to an industry that holds the assets of nearly 100 million investors.

While Attorney General Spitzer's timely actions and the recent Federal investigations have raised the issues of mutual fund abuses and the public awareness, much, much remains to be done. I look forward to hearing the regulators describe their findings to date and detail their road map of future actions.

Today, the Committee will hear from Eliot Spitzer, the Attorney General of New York; Stephen Cutler, Director of Enforcement at the U.S. Securities and Exchange Commission; and Robert Glauber, Chairman and CEO of the National Association of Securities Dealers. I look forward to your testimony.

Senator Sarbanes.

STATEMENT OF SENATOR PAUL S. SARBANES

Senator SARBANES. Thank you very much, Chairman Shelby.

At the outset, I want to commend Chairman Shelby for the ongoing oversight of the securities industry being conducted by this

Committee. This year alone, under Chairman Shelby's leadership, the Committee and the Securities Subcommittee of the Committee, of which Senator Enzi is the Chairman and Senator Dodd is the Ranking Member, have held 11 hearings involving securities matters, which clearly demonstrates how important the integrity and efficiency of the U.S. securities markets are in the estimation of the Congress.

Today's hearing gives us the opportunity to continue our examination of the status of current investigations into the mutual fund industry. We must learn more about the nature and scope of the misconduct, why it was allowed to continue undetected or unpunished for so long, and what are the most effective and appropriate remedies.

Mr. Chairman, I join with you in welcoming today's witnesses. Stephen Cutler is Director of the Enforcement Division at the U.S. Securities and Exchange Commission, an agency which in the past has been referred to as a "jewel among Government agencies." Although in recent years the SEC has been underfunded, the legislation we passed last year, the Sarbanes-Oxley Act, authorized and the Congress appropriated a significant increase in budget, which has led to more staff being hired in order to meet its regulatory needs. On Tuesday, Chairman Donaldson described the Commission's new regulatory initiatives, and I am looking forward this afternoon to hearing Mr. Cutler describe the enforcement activities.

I should note that the SEC's Division of Enforcement is today bringing significantly more enforcement actions. It is my understanding that the number of cases has increased from 484 in fiscal year 2001 to 598 in fiscal year 2002 to a current high of 679 in fiscal year 2003. It is also my understanding that with the significant increases in funding granted by the Congress, we have gone from $515 million in fiscal year 2002 to $716 million in fiscal year 2003, and the legislation we are working on now has $841.5 million for fiscal year 2004; that the SEC is working diligently to hire and train new employees for key divisions and that since this time last year, the Division of Enforcement has hired over 75 new attorneys and accountants.

I also look forward to hearing from Eliot Spitzer, the distinguished Attorney General of New York, who has repeatedly spearheaded major initiatives to protect investors. These have involved securities firms that issued fraudulent or misleading stock recommendations, which led to a landmark settlement agreement with Merrill Lynch. This action was followed by the global settlement entered into by 10 major securities firms, in which Federal and State regulators worked closely together to reform stock analyst practices. In September, just a couple of months ago, Attorney General Spitzer brought another landmark case against a major hedge fund for improper late trading and market timing in mutual funds. I think it is clear that his work and that of his counterparts in other States, whether attorney generals or securities commissioners, shows the important role that States play in protecting the investors.

Mr. Chairman, I want to commend both the SEC's Enforcement Division Director Steve Cutler, as well as Attorney General Spitzer for their outstanding efforts in enforcement. Tension between the

Commission and the States may very well go with the territory on occasion, but I think it is extremely important for investor protection, which is, after all, our prime goal, that the SEC and State regulators both are working to identify potential securities law violations and seeking to coordinate their investigations and enforcement activity wherever possible. I want to applaud the aggressive actions and competence of both of these dedicated public servants who are here today and are on this panel.

Then I also, of course, want to express our appreciation to Robert Glauber for joining us, the Chairman and CEO of the National Association of Securities Dealers, a self-regulatory organization for broker-dealers. The sales practices of stock brokers selling mutual funds have been a major focus of public attention and we are looking forward to hearing more about the NASD's examination and enforcement activities with respect to brokers. Mr. Glauber, we are pleased to once again have you back before the Committee.

Thank you, Mr. Chairman.

Chairman SHELBY. Senator Dodd.

STATEMENT OF SENATOR CHRISTOPHER J. DODD

Senator DODD. Thank you, Mr. Chairman. Let me add my voice to that of Senator Sarbanes and others and thank you for the series of hearings we have had on this subject matter. I certainly welcome our witnesses. To you, Bob, good to see you again, Mr. Glauber; and Mr. Cutler, Stephen, and Eliot Spitzer, the Attorney General, whom I have had the chance to get to know on several occasions. We thank all three of you for being here.

Again, Mr. Chairman, I want to thank you and thank our staffs as well. This is a rather crowded time around here. There is an awful lot going on, obviously, on the floor with major issues before us: The Fair Credit Reporting Act, which I know the Chairman and Senator Sarbanes and the staffs are working on, trying to resolve that issue before we leave here. So the staff, both Majority and Minority, of the Committee deserve a serious thanks for their tremendous commitment and hard work, and we are all very appreciative of the efforts being made, in addition to conducting these hearings.

Certainly, I want to thank our witnesses as well for the efforts they have been making to pursue and prosecuting the myriad of abuses that have been uncovered in and around the mutual fund business. I especially want to commend Eliot Spitzer. Your work, Mr. Spitzer, Mr. Attorney General, and the work of your staff has been a critical component in this effort, and without your diligent efforts as a "cop on the beat," it is unclear how much longer these abuses would have continued.

I would also be remiss if I did not express some concern over the seeming lack of coordination, and you and I have had a chance to talk about this already. I raised the issue the other day with Mr. Donaldson. And I do not want to dwell on the point here. You may want to address it in your own comments. The point Senator Sarbanes made is important, that the tension sometimes between the States and the Feds can work to the benefit of investors, but obviously when you can coordinate activities, that also can accrue to the benefit of everyone involved.

So while I do not doubt that both the SEC and the State enforcement officials have the best interests of investors in mind, I would urge all the parties to work in a more complementary fashion in order to fight securities fraud and abuse in our Nation.

Mutual funds, as we all know now, are a principal pathway that most investors achieve financial security. Over 95 million Americans and over $7 trillion have been invested in mutual funds. In the past, mutual funds have not only lived up to, but also in many cases exceeded the grand expectations of their investors. They are a true success story of our securities markets and our securities regulation.

However, as we all know, in recent months a series of revelations has shaken investor confidence and the promise of mutual funds. I think it is our obligation collectively to restore the fair of investors in mutual funds and those who manage them.

Late last week, my colleague Jon Corzine and I introduced—or announced an intention, rather, to introduce some legislation to address these abuses and shortcomings which have received so much attention. We did so because we believe that there is much more that needs to be done than just regulatory changes which address market timing and late trading abuses.

We believe that fundamental changes are needed in the way the funds are governed, and we intend to make substantive changes that enhance the independence of boards as well as provide greater accountability to fund shareholders. There is a widening gap between what investors believe mutual funds cost and the actual costs associated with those funds. Investors should have, in our view, a very clear, articulate understanding of what has become a maze of fees, loads, and hidden costs.

We also believe that we must take a close look at the current oversight of the mutual fund industry and determine if there are sufficient resources and if the current structure and manner of regulation is appropriate.

Mr. Chairman, I am looking forward to working with all of our colleagues here and addressing these issues, I hope in the not too distant future as other issues may take over our attention. So, I thank the Chair once again for having such a thoughtful set of hearings on the subject matter before we begin to legislate here.

Chairman SHELBY. Senator Johnson.

STATEMENT OF SENATOR TIM JOHNSON

Senator JOHNSON. Thank you, Chairman Shelby and Ranking Member Sarbanes, for holding today's hearing, and welcome to this distinguished panel. Frankly, Mr. Chairman, I am dismayed that just 1 year after we passed landmark corporate governance reform legislation, we are back again to deal with yet more wrongdoing in the marketplace.

Mr. Chairman, I find this particular string of scandals especially demoralizing because of the demographics of the victims. Until now, the mutual fund industry has presented itself as the champion of the little guy, the embodiment of the democratization of the capital markets. Mutual funds allow small investors to put their money to work through a diversified portfolio of investments managed by financial professionals otherwise unavailable to the aver-

age family. And the model has truly revolutionized economic opportunities for millions of Americans.

According to the Investment Company Institute, of the 95 million mutual fund shareholders, the median income of the mutual fund-owning household is $62,000. And 33 percent, a third of all mutual fund shareholders have household incomes under $50,000. Of these shareholders, a staggering 44 percent of household financial assets are held in mutual funds, almost half, a testament not only to the power of the investment vehicle, but also to the trust of the typical investor.

In short, mutual fund companies have been extremely successful at attracting their target demographic. What is now called into question, however, is whether these mutual fund companies have been as successful in fulfilling their fiduciary obligations to these customers.

Now, I appreciate that it is not fair to tarnish an entire industry because of the bad actions of some. But at this point, the theft seems to be so widespread, and so brazen, that I do not know that we can assume we are dealing with just a few bad apples. And the examples that have cropped up over and over again all share a theme: An imbalance of power that results in the relatively unsophisticated investor getting taken advantage of.

Among the most galling examples of fraud represent a sort of reverse Robin Hood: Hedge funds giving special after-hours trading access at the expense of mutual fund holders. Or private equity funds and hedge funds standing first in line for lucrative IPO shares.

Another example of where those in positions of fiduciary responsibility took advantage of their customers had to do with steering them to certain funds, not because they were appropriate for the investor, but because they yielded bigger commissions for the broker. I would be interested in survey results of how many investors understand the implications, for example, of buying "B shares" and the years of distribution fees that they imply.

In fact, this misuse of the professional investment adviser relationship bears close scrutiny. We know that mutual funds sell their product not simply as a diversified portfolio, but as access to professional investment advice that would otherwise be unaffordable to the average consumer. And if we look at all the statistics, yet again the industry has been successful in targeting its marketing. The ICI breaks out three categories of investors based on how they purchase their funds: Nearly half through defined contribution plans in the workplace, one-sixth through direct marketing from fund companies or discount brokers, and over a third through so-called "sales force" channels.

This last category, the sales force channel, is the most vulnerable to steering, and as one might expect, is the least educated investor class. And not surprisingly, this category of investors typically pays the highest fees. The sales force investors are on average 8 years older than investors who purchase shares through retirement plans. Almost 30 percent are retired, and nearly half lack a college education. By contrast, investors who use direct marketing channels such as online brokerages are younger, wealthier, and better educated.

Mr. Chairman, the point of these statistics is that both we in Congress and the mutual fund industry have a special obligation to ensure that this investor class is adequately protected. And these protections need to extend well beyond simple corporate governance issues. The Investment Company Act of 1940, known by most simply as "The Forty Act," is clearly due for a comprehensive checkup to make sure that it still works.

In addition to the governing statute, we clearly have a problem with enforcement. Without pointing fingers, enforcement is a point we need to address, and I hope the State and Federal enforcement arms can take their energy and motivation and begin working together on behalf of investors. Self-policing, as we learned during the Sarbanes-Oxley debates, is of limited use when good actors turn a blind eye to fraud and abuse and where enforcement agencies lack the capacity or the will to follow through.

Finally, it is hard to overstate the importance of overhauling the disclosure requirements related to fees, and perhaps even rethink whether fees need to be restricted. Under current law, investors have very good access to uniform performance and tax information, which allows them to compare funds on these scores. And while some of the fee arrangements are disclosed, investors do not have access to the information they need to make an intelligent evaluation of the true costs of their investments. We also need to take a hard look at the true characteristics of so-called soft-dollar arrangements, and I hope today's witnesses will at least address that point either in testimony or during the question period.

Mr. Chairman, the ICI's 2001 Profile of Mutual Fund Shareholders reveals that 91 percent of all mutual fund shareholders say the primary financial goal of their investment is to save for retirement. We have a special obligation to these investors, who work hard and save responsibly, to ensure that they have access to the marketplace in a first-rate, sound investment vehicle.

Thank you, Mr. Chairman.

Chairman SHELBY. Senator Corzine.

COMMENTS OF SENATOR JON S. CORZINE

Senator CORZINE. As my other colleagues have suggested, I congratulate you and the Ranking Member and others for cooperation and focus on this vital issue that we have.

One of the great pieces of both savings and the ability to allocate capital in this society is the mutual fund industry and mutual fund practice. And it is unfortunate that an industry that, long respected, has developed and created a number of problems for itself and really broken trust. I think I want to hear people that have looked at that, in specific talking about it, but we really do have to address the integrity if we want to have the kind of capital markets and savings structures that make this country great, getting money and investments to the places that will make our country really strong.

I look forward to working with all of you, and certainly Senator Dodd and I have some ideas with regard to these issues. The elements that have been discussed so readily in the press—late trading, market timing, and other issues—I think are important to deal with. But I think there is a fundamental problem here in just the

ability for any human being to understand actually what they are buying and what they are paying for when they are buying. So, I am hopeful we can get to comparative shopping and some kind of ability for people to know what it is they are paying for.

I am anxious to hear all of the witnesses speak to this issue, in particular, and there are a number of other issues that come to mind. But I appreciate it very much, and I commend all of those on the panel for, I think, their commitment to making our markets stronger. And I think in general they work very well together.

Chairman SHELBY. Senator Reed.

COMMENTS OF SENATOR JACK REED

Senator REED. Thank you very much, Mr. Chairman. Let me, too, commend you and Senator Sarbanes for continuing these hearings on a very important topic.

The obvious fact is that the securities markets rest on trust more than anything else, and what we have witnessed is a massive breach of trust. Let me commend Attorney General Spitzer and his colleagues at the State level for aggressively protecting the rights of investors. Thank you very much, Mr. Attorney General.

One of the issues that certainly will arise here is who should take the leadership role between the Federal Government, the SEC, the States. It reminds me of a saying that I learned as a young infantry lieutenant: Lead, follow, or get out of the way.

If the SEC is to be the leader, then it needs the resources and authority to do the job. Frankly, I think the resources are probably the more pressing issue at the moment. And it is not just a few more attorneys or a few more analysts. As Senator Corzine alluded to, the sophistication and the use of technology is monumental in terms of some of these products, and the SEC and the regulators need the same type of information software, and that is a significant investment that we will have to make. If we do not make those investments, then all of our exhortations to be more aggressive and more forceful I think will be just that—exhortations.

Thank you, Mr. Chairman. This is the beginning, I think, of a very important process.

Chairman SHELBY. Thank you, Senator Reed.

Mr. Spitzer, we will start with you. All of the witnesses' written testimony will be made part of the record in its entirety. Mr. Spitzer proceed as you wish.

STATEMENT OF ELIOT SPITZER
ATTORNEY GENERAL, STATE OF NEW YORK

Mr. SPITZER. Thank you, Mr. Chairman and esteemed Senators. I appreciate the invitation to appear once again in front of you and also to share the witness table once again with my great friend and colleague, Mr. Stephen Cutler, with whom we work diligently on a regular basis.

On September 3, my office announced the results of its investigation of the unlawful and improper trading practices of Canary Partners. Since that time, my office has worked closely with the SEC and others to uncover the extent to which mutual fund directors and managers breached their fiduciary responsibilities to the 95 million Americans who have invested $7 trillion in mutual funds.

Our continuing investigations reveal a systemic breakdown in mutual fund governance that allowed directors and managers to ignore the interests of investors. In fund after fund, what we have seen is the wholesale abandonment of fiduciary responsibilities. As Chairman William Donaldson put it to this Committee on Tuesday, "The industry lost sight of certain fundamental principles, including its responsibilities to the millions of people who entrusted their confidence and the fruits of their labor . . . to this industry for safekeeping."

Earlier today, my office, along with the SEC, brought actions against the founders of the Pilgrim Funds, Gary Pilgrim and Harold Baxter. These individuals served as directors of the various Pilgrim mutual funds and as fiduciaries of their investors' money. Nevertheless, when offered an opportunity to personally profit at the expense of their investors, they grabbed it. Although the Pilgrim Funds' prospectus prohibited shareholders from making more than four trades a year and their internal policies prohibited market timing, Mr. Pilgrim and his partners in another investment fund were permitted to engage in frequent market timing trades. Those trades were enormously profitable to Mr. Pilgrim and his partners, but were costly and detrimental to his shareholders. When Mr. Pilgrim was confronted with the choice between his lawful duty to investors and an unlawful opportunity for personal profit, he chose personal gain over his investors. That is the bad news. Unfortunately, there is certainly going to be more bad news to come as our investigations continue. But there is also good news.

The good news is that the process of addressing these systemic failures by considering systemwide reforms has begun. These reforms would alter the current governance structure of most funds by requiring them to have truly independent boards of directors. Seventy-five percent of directors, including the chairman, would be independent of the management companies that operate the funds. The independent directors would also oversee a compliance staff that will ensure that the fund's managers are acting in the best interests of the funds shareholders.

These reforms were all included in the package of proposals that I discussed when I testified before House and Senate Committees 2 weeks ago. I certainly agree with Chairman Donaldson that they are good "first steps." Taken together, these reforms will hopefully foster board action that is more for the benefit of shareholders and not that of managers.

At the same time, it is necessary for us to take the logical next step, which is to examine the fee arrangements between mutual funds and their managers. As I have said before, the 95 million Americans from 54 million households paid more than $70 billion in advisory and management fees in 2002. That comes to an average of $737 in fees paid by each individual investor and $1,292 paid by each household invested in mutual funds. These fees are in addition to the significant costs, such as trading costs, that are passed on to investors.

Investors who paid those fees—via deductions from their account, often without full disclosure—are entitled to know whether they are fair.

Some have questioned whether there is a nexus between the inquiry into fees that I am proposing and the investigation into the trading activities permitted by fund managers. The answer is yes.

The improper trading and the exorbitant fees charged are both consequences of a governance structure that permitted managers to enrich themselves at the expense of investors. We know that the directors and the managers breached their duties to investors in every conceivable manner. As regulators and law makers, our duty to investors is to investigate every manifestation of that breach and to return to investors any and all fees that were improper or inappropriate. This includes the fees that the managers received during the very time that they were violating their fiduciary duties to investors.

Moreover, the nexus between fees and the improper trading that we have uncovered is demonstrated by the fact that the managers who permitted late trading and market timing in many instances did so in return for increased investments in other funds that they managed. Mutual fund managers get paid a percentage of the funds under management, and therefore seek to increase their funds' asset base to increase their compensation. As one mutual fund manager put it in an especially memorable e-mail, "I have no interest in building a business around market timing, but at the same time, I do not want to turn away $10 to $20 million."

Simply stated, the desire for increased fees led the managers and directors to abandon their duty to investors and to condone improper and illegal activity. Common sense demands that we at least inquire whether the desire for increased fees also resulted in fee arrangements and charges that were improper.

Common sense and a simple review of the numbers also dictate that the fees charged to investors by the Putnam Funds continue to deserve scrutiny. In 2002, Putnam had approximately $279 billion under management. The $279 billion was divided between mutual fund money and institutional investors.

Our investigation has revealed that Putnam charged higher advisory fees for the mutual fund money that it managed, and charged lower fees for the advisory services that it provided to institutional investors. Here is what we have learned:

There was an extraordinarily large disparity between the rate of advisory fees charged to mutual fund investors and the rate paid by institutional investors. Mutual fund investors were charged 15 basis points or 40 percent more for advice than Putnam's other investors. In dollar terms, this fee disparity meant that in 2002, Putnam mutual fund investors paid $290 million more in advisory fees than they would have paid had they been charged the same rate that Putnam's institutional investors paid for advisory services.

At a minimum, this disparity raises several fundamental questions: Why were mutual fund investors charged more than institutional investors for advisory services? What steps, if any, did the directors who negotiated these fee contracts take to protect the interests of investors and to ensure that they paid the lowest possible rate? Did managers take advantage of a conflicted and complacent board to extract unjustifiably large fees?

These questions demand answers, and I will continue to insist that funds answer these questions as part of any settlement with my office.

Perhaps the most important question that needs to be answered is this: What can be done to convince nervous and skeptical investors that the fees that they are charged in the future are fair and subject to the competitive pressures of the marketplace? Let me offer a few possible answers.

First, mutual funds must be required to disclose the precise dollar amount of the fees charged to each investor in a quarterly or semiannual statement sent to the investor. This disclosure should be itemized, and consist of the dollar cost to the investor of advisory, management, marketing, and other administrative costs. Armed with this knowledge, investors can begin to engage in true comparison shopping among funds. There is no other industry that is exempt from informing their customers what they are being charged. It is an understatement to note that there is nothing about the manner in which the fund industry has conducted itself to warrant such an exemption here.

Second, we must impose a fiduciary duty on fund directors that requires them to negotiate fee contracts that are reasonable and in their investors' best interest. To determine reasonableness, directors must consider what institutional investors are charged for similar services, and the actual cost of the service being provided. While mutual funds do need some services that institutional investors do not require, there is no reason that they should pay more than institutional investors for services such as core money management. Moreover, the directors should be obligated to make public a meaningful analysis that supports the fee agreements that they have approved.

Third, we should consider requiring funds to obtain "most favored nations" clauses in their fee contracts. These contracts are common in procurement contracts throughout industry, and should not be ignored by the mutual fund industry itself. We should also consider requiring funds to put certain contracts out for competitive bidding. This may be especially suitable for many of the back-office and administrative services for which mutual funds pay.

Some in the industry question whether the competitive bidding is appropriate. Perhaps they should be reminded that many fund complexes already hire sub-advisors to perform the services that investors pay for. What happens to the money saved when management companies sub-contract for the services that they are charging investors for? We believe that the cost savings should be passed along to investors and not pocketed by the managers.

These ideas are not meant to suggest an exclusive or exhaustive list of the mechanisms available to achieve the goal of reducing fees. Rather, they are aimed at beginning a dialogue which is very necessary if we are to regain and retain the confidence of mutual fund investors.

Please permit me to make one final point. My office and the SEC have worked together cooperatively since the day I announced the settlement with the Canary Hedge Fund. Each day since then, there have been—and will continue to be—dozens of points of contact, coordination, and cooperation. On rare occasions we have

disagreed. As is the nature of these things, those rare moments of disagreement tend to get far more attention than all of our weeks of cooperation.

I will continue to speak up for investors when necessary, but that should not obscure the productive and mutually beneficial relationship that my office has forged with the SEC. It is my desire and intention to continue to foster that relationship.

Thank you.

Chairman SHELBY. Mr. Cutler.

STATEMENT OF STEPHEN M. CUTLER
DIRECTOR, DIVISION OF ENFORCEMENT
U.S. SECURITIES AND EXCHANGE COMMISSION

Mr. CUTLER. Thank you, Chairman Shelby, Ranking Member Sarbanes, and distinguished Senators. Good afternoon. Thank you for inviting me to testify today on behalf of the SEC concerning alleged abuses in the mutual fund area.

The growing number of illegal practices that have recently come to light involving the sale, trading, and operation of mutual funds is a betrayal of the millions of Americans who put their hard-earned savings into mutual funds. The conduct we are finding is unethical, it is illegal, and it is profoundly wrong.

Investors were led to believe that mutual funds were symbols of trustworthiness and security, and to the outrage and disappointment of all of us, that belief was, in many cases, misplaced. Rather than safeguarding the investors' money, some mutual funds, the brokers who sold them, and their personnel were busy feathering their own nests.

I have in the past talked of the crisis of conflicts in the financial services industry. What we are also seeing is a crisis of character. The SEC will follow the facts wherever they lead. We will bring enforcement actions wherever we find violations, and I assure you that the Commission is fully committed to ensuring that violators are promptly and appropriately punished. That process has, of course, already begun. Since Mr. Spitzer announced his action against Canary Capital Partners, we have brought half a dozen cases involving abusive market timing, late trading, and self-dealing practices. Indeed, just this morning, as the Attorney General mentioned, the SEC and his office sued Pilgrim Baxter and its two founders, Gary Pilgrim and Harold Baxter in connection with alleged market timing by a hedge fund in which Mr. Pilgrim was himself a significant investor, and for providing nonpublic fund portfolio information to a personal friend who was market timing fund shares.

In each of these cases we have worked with State regulators who have also filed their own charges. At the hearing on Tuesday and again at this hearing, Members of this Committee quite appropriately have expressed the need for cooperation among the various regulators working on these matters. I agree.

While regulatory competition has its place and its benefits, it is also incumbent upon all of us to put investors first and to direct all of our energies and efforts to that cause. That is what the investing public expects and that is what the investing public deserves. And while it might not always seem that way, as a general

matter I think we have been trying to do that. I know Mr. Spitzer would agree that our staffs have worked very well together and that our collaboration has resulted in stronger enforcement cases, and has certainly allowed us collectively to cover more territory than each of us could cover singly. As I have said before, we are both striving to achieve the same basic goals, the protection of investors and punishment of the wrongdoers. Now, we might not always see eye-to-eye on the best routes to get there and each of us has an obligation under those circumstances to do what we think best serves the investing public. Our partial settlement of the Putnam matter is, of course, a prime example of that.

I will not repeat all of what Chairman Donaldson said about it to you on Tuesday, except to say that we believe that it was important to get in place a restitution process and safeguards for Putnam's mutual fund investors now, and that we took great care to do so without sacrificing our claim for a substantial penalty against the firm, our pending case against the individuals, or our ability to bring additional causes of action and relief against Putnam or others in the event that further wrongdoing comes to light.

We did not, as I know Mr. Spitzer would have liked, require Putnam to revamp its disclosure of fees or the way in which fees are negotiated. We thought that was a subject better left to a case that involves violations relating to fees or to regulation of the industry as a whole, rather than the resolution of a case about fund trading by portfolio managers. But I agree with the sense of this Committee that it is time to put our differences with respect to the Putnam matter aside and to redouble our efforts to work together to bring cases expeditiously and to obtain meaningful relief and sanctions in all of our cases. I am committed to doing that, and I know that Mr. Spitzer is as well.

I think it is important to point out that the Commission has also been engaged in significant enforcement and examination activities in the mutual fund area in addition to late trading and market timing. The first area is mutual fund sales practices and fee disclosures. In particular, we are looking at just what prospective mutual fund investors are being told about revenue-sharing arrangements and other so-called shelf space incentives doled out by mutual fund management companies and mutual funds themselves to brokerage firms who agree to feature their funds.

On Monday of this week, in what opened a new chapter in the Commission's efforts to combat abuse in the sale of mutual funds, we sued Morgan Stanley. Morgan Stanley had established an exclusive club of 16 mutual fund families in what it called its Partners Program. Under that program Morgan Stanley gave these fund families premium shelf space. The firm encouraged the sales force to sell shares of the Partners Program funds and even paid its sales people special incentives to sell those funds. Here is why. Under the program every time Morgan Stanley sold its customers shares of funds in the club, the fund family was obligated to pay Morgan Stanley a percentage of the sales price over and above the ordinary commissions and loads, but customers did not know about these special shelf space payments.

Morgan Stanley agreed to settle this action by paying $50 million, all of which, thanks to the Sarbanes-Oxley Act, will be placed

in a fair fund and returned to investors. In addition, Morgan Stanley has agreed to significant undertakings to enable customers to see clearly and plainly what Morgan Stanley has to gain from selling them one fund over another.

In light of the issues raised by the case, the Commission is conducting an examination sweep of some 15 different broker-dealers to determine exactly what payments are being made by funds, the form of those payments, the shelf space benefits that broker-dealers provide, and most importantly, just what these firms tell their investors about these practices.

And the potential disclosure failures and breaches of trust spotlighted in the case are not limited to broker-dealers. We are also looking very closely at the role of the mutual fund companies themselves. Indeed, the aspect of the case that I find perhaps most troubling is this: Morgan Stanley said to the fund families that are part of the Partners Program—you can pay us in one of two ways. Either the fund management company can pay us in cash, or the mutual funds you manage can defray the fund management company's obligation by giving us a multiple of that amount in the form of extra commission business on fund portfolio transactions. Faced with that choice, some of the fund companies, rather than reaching into their own pocket to pay what they owed, reached into the pockets of their mutual fund shareholders and paid in commission dollars instead.

Mr. Chairman, you can be certain that we are pursuing that issue, among others, as our investigation continues, and our exam sweep goes forward.

Our second area of focus is the sale of different classes of shares in the same mutual fund. Very frequently a fund will have issued two or more classes of shares with different loads and other fee characteristics. In the last 6 months we have brought three enforcement actions in connection with alleged recommendations that customers purchase one class of shares when the firm should have been recommending another. We charged Morgan Stanley with violations in this area too, by the way.

The third area is the abuse of so-called breakpoints, which I know Mr. Glauber will speak about. Quite simply, we have found numerous instances in which brokerage firms did not give investors the volume discounts, sometimes called breakpoint discounts, to which they were entitled. Earlier this month, together with the NASD, we issued Wells notices concerning breakpoint violations to a significant number of firms.

The fourth area I want to mention is the pricing of mutual funds beyond the context of market timing. We are actively looking at a number of situations in which funds dramatically wrote down their net asset values in a manner that raises serious questions about how they price their fund shares in the first place.

Before I conclude, I feel compelled to address one more topic. These days it has become fashionable in some quarters not just to critique the Commission, but also to question the will of the Agency and its staff. Yes, the Agency, including the enforcement program can and should continuously look for ways to improve our effectiveness, and I am steadfastly determined to do that. But I cannot

emphasize enough the dedication, the commitment, and the professionalism of our enforcement staff. I am proud to be one of them.

In our just concluded fiscal year, as Senator Sarbanes mentioned, the Commission brought a record 679 enforcement cases, and that is a 40 percent jump from just 2 years ago with a very limited increase in resources during that same period. With the recent badly needed budget increase that you have been responsible for giving us, we have now begun to see additional resources, and they will allow us to look more proactively, to look around the corner for the next fraud or abuse. Indeed, that is what Chairman Donaldson's risk assessment initiative is seeking to achieve. With respect to mutual funds, I know that the Agency's routine inspection and examination efforts will be improved by adding new staff, increasing the frequency of examinations and digging deeper into fund operations. We are working aggressively to clean up the mutual fund abuses that we have seen and are committed to making sure that they cannot recur.

Thank you.

Chairman SHELBY. Thank you.

Mr. Glauber.

STATEMENT OF ROBERT R. GLAUBER
CHAIRMAN AND CHIEF EXECUTIVE OFFICER
NATIONAL ASSOCIATION OF SECURITIES DEALERS

Mr. GLAUBER. Good afternoon, Mr. Chairman and Members of the Committee. I appreciate this opportunity to testify on behalf of NASD about our ongoing investigations and actions regarding the mutual fund industry.

The picture that has emerged from current investigations into marketing of mutual funds is appalling and simply unacceptable. While regulators are still investigating the contours of this behavior, it is clearly not just a case of a few bad apples.

At Tuesday's hearing before this Committee, SEC Chairman Donaldson announced a series of reforms in the realm of disclosure that NASD supports. Investors deserve clear and easy-to-read disclosure that tells them of all the costs associated with their mutual funds. Not just the load and fees, but also the other arrangements that affect the price investors pay for the fund, including Commission expenses and compensation arrangements between the broker and the fund. One of the bedrock principles of our free market system is that all participants have access to information about prices and costs that can influence their decisions. When this information is hidden or distorted, investors are not able to make the best decisions about where to invest their money.

When they have this information, investors can be in the best position to discipline the behavior of those who create and sell these investment products. In line with Chairman Donaldson's recommendations, NASD recently proposed a rule requiring disclosure of two types of cash compensation, payments for shelf space by mutual fund advisers to brokerage firms that sell their funds, and differential compensation paid by a brokerage firm to its salesmen to sell the firm's proprietary funds. Customers have a right to know that these compensation differences exist. They create a serious potential for conflict of interest.

We are also looking at other areas for improved disclosure including soft-dollar arrangements. Again, soft-dollar payments both affect the cost to investors from owning a fund and potentially create conflicts of interest between the fund adviser and shareholders.

The enormous growth in popularity of mutual funds in recent years has led NASD to step up its oversight of how our regulated firms sell these funds. While NASD does not have jurisdiction or authority over mutual funds or their advisers, we do regulate the sales practices of the broker-dealers who provide one distribution mechanism for mutual funds.

Our regulatory and enforcement focus has been on the suitability of the mutual fund share classes that brokers recommend, the sales practices brokers use, the disclosures brokers make to investors, compensation payment brokers get from funds and whether the brokers give customers appropriate breakpoint discounts. We have brought some 60 enforcement cases this year in the mutual fund area, and more than 200 over the last 3 years.

Allow me to start with breakpoints. Through our routine examinations we have found that in one out of five transactions in which investors were entitled to a breakpoint discount that discount was not delivered.

Chairman SHELBY. Mr. Glauber, explain to us again what you mean by "breakpoint."

Mr. GLAUBER. Very simply, Mr. Chairman, it is a volume discount that investors are entitled to if they buy, in many cases, greater than $25,000 worth of a mutual fund, it is just that simple.

Chairman SHELBY. Sure.

Mr. GLAUBER. Thus many brokers charge the wrong sales load to thousands of mutual fund investors, in effect, overcharging investors, by our conservative estimate, $86 million in the past 2 years. NASD has directed firms to make refunds.

In the next several weeks we will initiate a number of enforcement actions seeking significant penalties, and we have launched an advertising campaign urging investors to seek proper restitution for these overcharges.

Next let me focus on sales incentives. Brokers are prohibited from holding sales contests that give greater weight to their own companies' mutual funds over other funds. These types of contests increase the potential for brokers to steer customers toward investments that are financially rewarding for the broker, but may not be the best fit for the investor. In September, we brought an enforcement action against Morgan Stanley for using sales contests to motivate its brokers to sell Morgan Stanley's own funds. The sales contest rewarded brokers with prizes such as ticket to Britney Spears and the Rolling Stones concerts. These cases resulted in one of the largest fines ever imposed in a mutual fund sales case.

Just this week, NASD with the SEC announced further enforcement action against Morgan Stanley for giving preferential treatment to certain mutual fund companies in return for millions of dollars in brokerage commissions. Over the last 2 years, NASD has brought more than a dozen major cases against brokers who have inappropriately recommended that investors buy Class B shares of mutual funds in which investors incur a higher cost and brokers

receive higher commissions. We have more than 50 additional investigations of inappropriate Class B sales in the pipeline.

This kind of enforcement effort is continuing with great vigor at NASD. We are now looking at about two dozen firms for their practices of accepting brokerage commissions in exchange for placing particular mutual funds on a preferred list, and precisely what Mr. Cutler referred to. In this effort we are investigating all types of firms including discount and online brokers and fund distributors.

The role of brokers and late trading and market timing has been a more recent focus of investigation at NASD. In September, we sought information regarding these practices from 160 firms. Our review indicates that a number of firms clearly received and entered late trades. These investigations, more than 30 so far, have been referred to our Enforcement Division.

As we continue our examinations and investigations into these matters, we will enforce NASD's rules with a full range of disciplinary options including fines, restitution to customers, and the potential for expulsion from the industry. These issues in the areas of broker sales and mutual funds go to the very heart of our mission to protect investors, strengthen market integrity, and rebuild investor confidence.

I thank the Committee for its leadership and for asking me to testify today.

Chairman SHELBY. Thank you.

Mr. Cutler, I will start with you. It appears that late trading and market timing practices have long been open secrets in the fund industry. Some people have suggested that the SEC failed to stop the abuses because it was out of touch with the markets and it could not effectively coordinate among its internal divisions, that is in the SEC. I recognize that you cannot speak to the operation of the SEC's Examination Division. You are head of the Enforcement Division, which is the division responsible, as I understand it, for monitoring the funds' ongoing legal compliance, is that correct?

Mr. CUTLER. It is.

Chairman SHELBY. With this in mind, how is it that such misconduct could continue for so long without detection and enforcement by the SEC? Was it a lack of attention, a lack of resources? Assuming that in a $7 trillion interest like most of us, that everything was fine and rosy or what?

Mr. CUTLER. I think that is a very good and fair question. The one thing I can assure you, Senator, and Chairman, is that it has certainly not been a lack of will. And as you have rightly pointed out, I think the Agency, and in particular our inspection program, was severely underfunded for a number of years. There are approximately 8,000 mutual funds in America. We have had on the order of 350 examiners responsible for inspecting that entire industry. That has not been enough.

Chairman SHELBY. Tell us, if you can, for the record, how many examinations in the last say 3 years—just use that as a calendar—have you done at the SEC of the mutual fund industry or the companies that make up the mutual fund industry, and if you do not have that now, could you furnish this for the Committee?

Mr. CUTLER. That would be better, because I would be guessing, Mr. Chairman. I think it is on the order of 2 to 300 complexes are

examined in any 1 year, but we need to get you the precise figures because it is not my division.

Chairman SHELBY. Sure, I understand that. Along those same lines, could you share with the Banking Committee, the Members, and the staff would be interested in this, what your examinations found, and were any of the areas, market timing, breakpoints, all of this, was there evidence of that going on in your examinations? And what did you do about it if anything?

Mr. CUTLER. I will start with the market timing question, because I think that is what launched all of this a couple of months ago in that particular area, in the Canary Capital and what followed from it. Again, I have to give you my impressions given where I sit. My impression of what happened here is that you had an industry that over the years was beseeching the Commission to give them more tools to combat market timing.

Chairman SHELBY. Well, how did they do that? You say you were beseeching.

Mr. CUTLER. With greater redemption fees, right? Give us the power to stop this. We hate it. I think that the mindset was—and I am not trying to excuse it, I am just trying to explain it—was that here you had a potential set of misconduct that the industry was saying we hate, we are trying to do everything we can to stop. The notion that the mutual fund industry was complicit——

Chairman SHELBY. Wait a minute. They said that they wanted to stop. But you can stop misconduct if you want to, can you not? I mean, not you. I am speaking of the industry themselves. They were kind of self-regulatory to a certain extent, were they not?

Mr. CUTLER. There are ways to stop it, but I would submit, Mr. Chairman, that there are ways to avoid being stopped.

Chairman SHELBY. We know that.

Mr. CUTLER. Yes. We have seen it, for example, by way of omnibus accounts.

Chairman SHELBY. Manipulation of the whole process.

Mr. CUTLER. Sorry?

Chairman SHELBY. Were they manipulating the whole process?

Mr. CUTLER. Well, we now know that there were many people who were manipulating the process, and those people are going to be severely punished.

Chairman SHELBY. Did you know any of this, say, about 18 months ago?

Mr. CUTLER. I do not believe that the Agency did.

Chairman SHELBY. You had no inkling?

Mr. CUTLER. I do not believe that the Agency knew that there was wrongdoing in the market timing and late trading area. That is my impression from where I sit.

Chairman SHELBY. But you are going to check the record and the examinations and share this information.

Mr. CUTLER. I think the examination people have gone back and checked their exams and this was something that—there are many things to examine for. There are many, many different areas.

Chairman SHELBY. We want to know. We should be able to know for sure, and I will ask Chairman Donaldson to furnish this information to us.

Mr. CUTLER. We will get you all the information you want, Mr. Chairman. I should also add that in the area of breakpoints, in the area of sales practices, those have been areas of acute focus by our examination staff, and they have helped develop the cases that you are now hearing about in those areas, the breakpoint cases, the fee disclosure cases.

Chairman SHELBY. I guess my point is, in an industry of $7 trillion, $7 trillion is a little money, to say the least. If there were open secrets that all this was going on, it looks to me like somebody in Enforcement or Examination would have known something about it and would have acted on it. That is just a common sense question, is it not? Because as widespread as it looks like it is going to be in the industry, we are just trying to get to the facts.

Mr. CUTLER. I think it is a very fair question, and I can tell you, Senator, that we are determined to assure that going forward we have the tools to address just that question, that we are working proactively and we are working in concert. That is, that people from Enforcement, from our Division of Investment Management, and from our Office of Compliance Inspections and Examinations, have sat down together, have reviewed the examinations that have taken place, in particular, any examination that has raised, for example, any enforcement question, and figured out what to do with this and what it means to us, and thought about questions in a broad way. Because you are right in the sense that clearly market timing, and do not forget, market timing is not, per se, illegal, the practice of market timing was not a secret. What was a secret was that it was being used abusively, that it was being used in violation of law, and I think it is incumbent upon all of us to——

Chairman SHELBY. Was this investigated? If it was not a secret was it investigated by the SEC, and if not, why not?

Mr. CUTLER. I do not believe it was, and again, all I can tell you in that regard is I think that it was viewed as something that the industry was trying to stop, not something that the industry was actually complicit in facilitating.

Chairman SHELBY. I asked Chairman Donaldson a couple of days ago this question. I will just touch on it with you. We wanted to know for the Committee and the staff, the Members and the staff, how much in resources were expended by the Securities and Exchange Commission, say, in the last 5 years—we will just use that as a calendar date—on the oversight of the mutual fund industry? You might want to do this for the record. I think the Chairman is trying to get this together. In other words, was this an area that was greatly neglected because there had not been any apparent scandals that were widespread in the public, or what was it?

Mr. CUTLER. I can tell you from an enforcement perspective it was not neglected.

Chairman SHELBY. Will you furnish this information for the Committee?

Mr. CUTLER. Yes, we certainly will. Certainly we have a broad mandate, and there have been lots of areas of focus, and I will tell you that in the last 3 to 4 years, I think the Agency has rightly been focused on the corporate scandals that we have read way too much about, the Enrons and the WorldComs. But we have to be everywhere——

Chairman SHELBY. You do not have to explain that to us who have been on the Banking Committee a long time. We know you have a broad mandate here, but we want to know what you are doing or what you did, if anything, in the scope of that mandate as far as these funds are concerned.

My next question is how can the SEC, Mr. Cutler, modify its internal operations to perhaps prevent another such industry-wide abuse from going unaddressed, neglected, by any of the SEC's internal division? In other words, how will Chairman Donaldson's risk management initiative affect a situation like this, if it will?

Mr. CUTLER. I think it will, in that he is looking from a 30,000 foot perspective to ensure that we do not miss anything through whatever cracks might otherwise develop between divisions, and I think that is critical.

At the same time, from my own parochial enforcement perspective, I too want us to be more proactive, and I have actually posted jobs to bring substantive expertise within the Enforcement Division, someone who knows trading and markets, someone who knows the investment company and investment adviser world, someone who knows corporate accounting and disclosure, so that they can help us from a strategic planning perspective where should we be putting our resources? What might we be missing? What should we take a flyer on and investigate even if we do not have a referral from our examination program?

Chairman SHELBY. And what if you did have a referral and you neglected it?

Mr. CUTLER. Well, I will not let that happen, and I will tell you we have already put into place a mechanism I hope that will ensure that does not happen. We have a working group consisting of my colleagues in those other divisions to review any exams that produce enforcement related issues.

Chairman SHELBY. Mr. Spitzer, you have been very involved and I thank you for your involvement in trying to bring investor confidence to the capital markets.

You have been quoted as saying that you will not enter into any settlements until the mutual fund industry agrees to make significant structural changes such as reforms to fee structures, et cetera. Former SEC Chairman Arthur Levitt was quoted as stating the other day: "As to the longer term question of fees, that issue should not be addressed in an enforcement action, but is an issue for the SEC Commission." What is your response to that statement and the contention that the SEC is a primary policymaker for the national market?

Mr. SPITZER. Mr. Chairman, I am loathe to disagree with former Chairman Levitt, who is not only a friend and a colleague, but also somebody whom I respect enormously.

Having said that, let me take a stab at it, and the answer I think is embedded in the testimony that I delivered today, that we see fund abuse as part and parcel of the violation of fiduciary obligation, one other evidence of which is late trading, market timing, failure to observe breakpoints, so that I would be loathe to enter a settlement which addressed the particular manifestations of fiduciary breach without confronting the larger issue itself.

And I would note that Mr. Glauber referred to a very important point of failure to observe breakpoints is reflecting, in their conservative estimate, an $86 million loss.

Chairman SHELBY. How many firms did he——

Mr. SPITZER. That was not——

Mr. GLAUBER. I did not give the number, but we have looked at 650 firms.

Chairman SHELBY. Over 600 firms.

Mr. SPITZER. But with respect merely to the differential between fees charged mutual funds and institutional investors, the 15 basis points at Putnam translated into $290 million net loss to those investors in one firm. Now, we have to massage those numbers. This is based on their delivery of numbers to us.

The point is, the fee issue is so pervasive and cuts so deeply to the heart of whether or not these entities are living up to their fiduciary duty, that I do not want to settle with them unless and until we begin to address that issue.

Chairman SHELBY. I am not indicting you. I am just asking you a question.

Mr. SPITZER. I am glad of that.

[Laughter.]

I would go back to the statute book to see if you could, but——

[Laughter.]

The issue I would point out is that Mr. Cutler and I have had a series of conversations about how, when, whether, and where to begin to undertake this discussion of fees, and I know that many of the Members of this Committee also are not only intrigued by it, but also believe that it is perhaps the essential point we have to address. So, I believe we are making real progress in moving that debate forward.

Chairman SHELBY. Attorney General Spitzer, how do you respond to the contention that State regulators who lack rulemaking authority are using the threat of prosecution to extract concessions that have nothing to do with the alleged violations of law, or on the other hand, are they all mixed together?

Mr. SPITZER. First, I would reflect back on the cases we have brought over the last 2 years or so when we have tried to confront structural issues in the securities markets that we thought needed to be addressed that had not been addressed, and first was the failure of research, and more recently the failure of the mutual fund industry to govern itself within fair bounds of fiduciary duty. I think if you look at the remedies we have sought in each case, they flow directly from the nature of the wrongdoing that we have seen.

Where we have verged into the area of rulemaking, we have done so only in concert with the SEC. I have been very conscious of that boundary line, and it is as a consequence of that that I early on, both last year with respect to research and this year the same day we began our post-Canary investigation, called Mr. Cutler and said we have to get into this together.

Nobody, I would hope, at the State level has disputed or stated other than that the SEC is the primary regulator and has the final rulemaking authority. So, we are conscious of that divide and tried to reflect it.

Chairman SHELBY. But sometimes you have a situation where you have civil and criminal culpability, do you not?

Mr. SPITZER. Oh, absolutely. The boundary line between those two is usually one of judgment calls rather than one of stark bright lines that can be defined.

Chairman SHELBY. Mr. Glauber, given the apparent failure of self-regulation in the context of the global settlement and of the recent mutual fund trading abuses, do you think now is an appropriate time to reconsider the structure of our regulatory structure and its reliance on self-regulatory organizations?

Mr. GLAUBER. Well, I think it surely is worthwhile to ask the question.

Chairman SHELBY. Raise the level of debate on it.

Mr. GLAUBER. Oh, absolutely. I believe that self-regulation has proven itself very effective in many, many areas. Indeed, in the areas of sales practices related to mutual funds, I think the history of self-regulation and of the NASD is one that is quite respectable.

I recited what we have done on breakpoints, on sales contests, on inappropriate sale of Class B shares. So, I think really there has been a great benefit to the investing public from what is an organization in our case which is over 2,000 people, with a budget of roughly $500 million that is geared and directed toward protecting investors. Do we catch everything? Of course not. But I think we really have made a very important contribution to the protection of investors and to the preservation of market integrity.

Chairman SHELBY. Absolutely.

Mr. Spitzer, I understand that the scope of your investigations are continually expanding because one thing brings another, as we all know.

Mr. SPITZER. Yes, sir.

Chairman SHELBY. What practices do you anticipate—or maybe you cannot say—investigating next? And when do you expect to complete your industry-wide probe? Or is it just too big to say at this point?

Mr. SPITZER. Well, Mr. Cutler asked me that this morning, also. [Laughter.]

Mr. CUTLER. Do I get a chance to object?

Mr. SPITZER. Mr. Chairman, I am not sure it is possible to say what is next. As you suggested, unfortunately, one investigation begets another, and what began with Canary has spawned a range of other abuses that have now been played out, some of them publicly, many of them not yet——

Chairman SHELBY. It runs right through the whole industry, maybe not every fund, but it is very widespread. It is going to take a while.

Mr. SPITZER. It will take a long time. Let me just merely throw out one area that we are delving into, all of us collectively, that I think is highlighted by the case we filed this morning, the Pilgrim case, and that is the dual interest in a hedge fund and a mutual fund, simultaneous investment or management that creates very difficult and complex tensions that are often very difficult for people to mediate or temptations that they cannot resist or have been unable to resist. And we are seeing, where there are those simulta-

neous investments and interests, problems that emerge and that is an area that we are pursuing.

Chairman SHELBY. Senator Sarbanes.

Senator SARBANES. Thank you very much, Mr. Chairman.

Mr. Cutler, has the SEC studied the use of commissions by mutual funds to finance the marketing and distribution of fund shares?

Mr. CUTLER. I do believe that is an issue that has received a lot of attention and focus by our other divisions, so I cannot speak to it personally. But certainly if you look at the case we brought earlier this week, the case against Morgan Stanley, one aspect of that case is the use of commission dollars by mutual funds who are part of that Partners Program that Morgan Stanley had to pay Morgan Stanley for shelf space. And we certainly do not think that Morgan Stanley's customers understood that when they were buying a mutual fund share, that part of their own investment was going to be used by way of commission dollars to defray the obligations of the mutual fund family in which they were invested. I think it is a very important issue.

Senator SARBANES. These commission-generated payments that you have just referred to of marketing and distribution, as I understand it, are currently not itemized or disclosed to fund shareholders by their funds as a general proposition. Is that correct?

Mr. CUTLER. Senator, I do not believe they are in the 12b–1 fees that are ordinarily disclosed.

Senator SARBANES. Isn't it a violation of 12b–1? As I understand 12b–1, it permits funds to use their assets, which is what is happening here, to pay for distribution only if such payments are made pursuant to a plan approved by fund shareholders and annually reviewed and approved by the fund's board. Apparently, that is not happening in these cases, is it?

Mr. CUTLER. Not that I am aware of. And then I think what the mutual funds would say is there is a difference between commission dollars and hard dollars, but I would take the different view. I agree with you, Senator, I think it is quite problematic when mutual funds are using commission dollars on fund portfolio transactions to defray expenses or obligations relating to distribution.

Senator SARBANES. Does either of the other panelists want to add anything on this issue? Mr. Glauber.

Mr. GLAUBER. Thank you, Senator Sarbanes. The use of directed brokerage commission dollars actually does violate an NASD rule, and that is why we joined Mr. Cutler and the SEC in the case this week against Morgan Stanley.

Mr. SPITZER. No, sir, I have nothing to add on that.

Senator SARBANES. Okay. Let me see how to phrase this. I am becoming increasingly concerned that a few firms, some of them, in a traditional view, leading firms, seem to be getting into trouble over and over again. And so, we read a case, the regulators come in, and they do a $50 million fine or something, and a strong admonition, and then there is another case where something has gone amiss and so they get punished there. But it all begins to smack a little bit of the cost of doing business.

How do you propose to deal with these firms who seem to be repeat offenders? You know, there is a bad action and they get

caught and admonished for it, and then they come along and something else happens, not too much later.

Chairman SHELBY. Something the next day.

Senator SARBANES. Yes.

Mr. SPITZER. Senator, if I could take a shot at that, it is obviously a concern we all share, and I think we are all loathe to believe that there is some notion of a "too big to fail" protection that would extend to some of these entities and, therefore, almost an immunity that permits them to pay a fine, move on, and, as you say, build this into their cost of doing business.

In my conversations with a certain number of the senior executives at these firms over the last few months, I have made it really quite clear to them that where there is recidivism, we will deal with them the way that we deal with recidivists, whether it is a robbery or any other street crime, and that is that there will be no second chance.

I do not want to speak for anybody else. I am viewing this case as one where the penalties should be presumed to be significantly larger, sterner, perhaps even more draconian, than they were last year when we dealt with the research issue.

To a certain extent, the rationale for that is that last year we did at the end of the day in our global settlement change the rules by which the investment houses were operating. This year, the violations we are seeing relate to rules that were reasonably clear, understood, and we have nothing more than new theories of larceny that are being played out by the malefactors.

As a consequence, I think it is fair to presume that there will be criminal cases brought against institutions, and that may be the death penalty for those institutions. But, in my view, that is the only option which we are now left with.

Senator SARBANES. Mr. Glauber.

Mr. GLAUBER. As I am sure you know, in the case generally of smaller firms, we have actually used our sanction of putting them out of the industry.

In the case of larger firms, where I think sanction would be inappropriate, we are giving very serious consideration to requiring that they cease operation in certain lines of business for a fixed period of time, basically putting them in the penalty box, if you will, for that line of business for a period of time, which I think would be a very serious sanction, very serious economic sanctions, and in some cases appropriate.

Senator SARBANES. But is the culture within those firms such that the people who have been engaged in those practices have kind of an attitude, well, it is too bad you got caught, you were making a lot of money for us, and we know that, and we have to now adjust somehow to take this into account? Are they developing the kind of DNA that Donaldson talked about in terms of high standards?

We had a witness here, the former head of Johnson and Johnson. This was when we were doing the corporate governance issues. And he was very good because he said they had a corporate culture that really came down very hard, it just did not tolerate the transgressions. You have a sense here that there is a tolerance for these

transgressions, and people say, well, it is too bad and everything, but that is that. What is your sense of the corporate culture?

Mr. GLAUBER. I think the best answer I can give you, Senator Sarbanes, is that cultures differ a great deal from one firm to another, and the DNA differs, as you have said. In some firms, I think sanctions of this sort really do change behavior and change it dramatically. In other cases, it may not.

Senator SARBANES. Obviously, you need to think of developing the kind of sanctions that will effectively change behavior everywhere; otherwise, you are still down this slippery slope.

Mr. GLAUBER. I think that is a perfectly fair point.

Senator SARBANES. Do you have any observations to make about this, Mr. Cutler?

Mr. CUTLER. I think, Senator Sarbanes, that you have put your finger on exactly the right question, which is: What is the corporate culture? And is the problem that you saw 2 or 3 years ago and the problem that you are seeing today reflective of a systemic failure, of a problem at the top, of a corporate culture that is sick? Or as can sometimes be the case, is it two separate problems? I think it is incumbent upon us to weigh that, to figure it out, and to ensure that we sanction appropriately, including determining whether higher sanctions are appropriate if the conduct reflects a problem that is systemic.

Senator SARBANES. Just one more?

Chairman SHELBY. Go ahead, Senator.

Senator SARBANES. Speaking of the culture of an institution, let me ask you: What can you tell us about the coordination between the Office of Compliance Inspections and Examinations, the Office of Investment Management, and the Office of Enforcement? And, particularly, has the Division of Enforcement been getting all the assistance it needs from other divisions and offices within the SEC, for example, the Office of Investment Management? If not, what can be done to improve the coordination between and amongst these offices?

Mr. CUTLER. I tried to address that a little bit earlier. We are concerned about our ability to coordinate, and we are addressing that and have actively addressed it in recent months. We are now ensuring that all referrals that raise enforcement-related issues connected to the mutual fund area are reviewed by a team that consists of enforcement, investment management, and the inspection program.

We otherwise have gotten together or begun to get together on a regular basis to determine whether there are common issues that we should be addressing. And as you heard from Chairman Donaldson earlier this week, I think he has a risk assessment initiative that is designed to ensure that there is more and better coordination among the various offices at the Commission.

Senator SARBANES. What is the perception, Mr. Glauber, in the industry of the extent of or lack of coordination within the SEC in order to address these issues?

Mr. GLAUBER. I really am at a loss to give you a good answer to that. The SEC, like our organization, is a large organization divided into divisions. It is a challenge to coordinate them. We work hard, and I know the SEC works very hard to do it.

Senator SARBANES. All right.

Thank you, Mr. Chairman.

Chairman SHELBY. Thank you.

I want to pick up on some of what Senator Sarbanes talked about. You found out or had reason to believe that people who look at this misconduct and so forth as just doing business, you know, a cost of doing business. Maybe they had not learned. They just figured they are going to maybe learn some other way to do it. And, Attorney General Spitzer, you referenced street crimes. You are the Attorney General, and you know a lot about street crimes, robberies, strong-arm robbery, thieving from the people and so forth, stealing. But, gosh, this is one of the big heists of the country. There are billions of dollars involved—millions, if not billions. We do not know how much now. But we do know the treasury is great, $7 trillion involved, about 100 million Americans involved in the funds. So the street crimes of America, which are bad, but as far as stealing and robbery and petty thievery, gosh, they would be pikers when they are compared to what we could see here or we will find out here. Do you agree?

Mr. SPITZER. Yes, sir, I agree entirely. If I could just add one clarification. You suggested that because I was from New York, therefore, I knew a lot about crime.

Chairman SHELBY. I think that you know a lot about crime as a prosecutor.

Mr. SPITZER. I just wanted to clarify that. We actually have among the lower crime rates in the Nation. I will be parochial and add that.

Chairman SHELBY. That is because you have been vigorously prosecuting it.

Mr. SPITZER. Absolutely, sir.

Senator SARBANES. We will be sure that Senator Schumer gets a copy of this portion of the transcript.

[Laughter.]

Chairman SHELBY. We will.

Mr. SPITZER. Thank you, Senator. But I agree with the premise behind your question. Comparatively, the dollars involved here are exponentially greater than the economic harm that results from the larcenies committed on the street level. And that is why I made the point that the 15 basis points at Putnam in terms of the advisory services translates itself into a $290 million cost.

Chairman SHELBY. You do not need a gun to steal from people, do you?

Mr. SPITZER. Well, somebody made the observation, Senator, that the smartest way to steal is one penny at a time from many people so that nobody really objects to that small incremental fee. Yet by the time you aggregate all that money, it is a vast sum of money. And that, unfortunately, is what we have seen in the financial services sector, incremental fees that are layered upon each other. I think it goes back to Senator Sarbanes' comment. It is that very difficult interface between the 90 million investors whom we have asked to come into the marketplace and the very few, the very large institutions who look at these individual accounts and see them as very small-margin returns and, therefore, keep saying:

How can we get more and more out of that customer? That is where this drive for fees comes from.

Chairman SHELBY. You quantify that and you have a lot in the aggregate, haven't you?

Mr. SPITZER. Absolutely, sir.

Chairman SHELBY. Mr. Cutler, have you considered—and I know this is not a complete deal; I hope it is just beginning—referring certain investigations to the Department of Justice for criminal investigation and prosecution? And if you have not, will you under the right circumstances?

Mr. CUTLER. Yes. I should add that my colleague to the right, Mr. Spitzer, has criminal authority. We are working very closely with him.

Chairman SHELBY. But so does the Justice Department.

Mr. CUTLER. That is right, but there probably can only be so many criminal prosecutions of the same person at the same time.

Chairman SHELBY. I understand that.

Mr. CUTLER. Actually, the two of us together have been coordinating with U.S. Attorney's Offices to the extent that they would be involved, but already Mr. Spitzer has brought criminal cases where we have brought companion civil cases. And I suspect that that will continue.

Chairman SHELBY. I have a letter here from John Snow, Secretary of the Treasury, and Alan Greenspan, Chairman of the Board of the Federal Reserve, to me as Chairman of the Banking Committee outlining a number of their thoughts on this, including criminals who use mutual funds to steal from investors or otherwise engage, as I read the letter, in fraud, and these must be apprehended and punished promptly in order to preserve the integrity of these financial institutions and preserve the trust placed in them. I want to put this letter in the record and share it with you, if I can.

Chairman SHELBY. Mr. Glauber, Chairman Donaldson, on Tuesday of this week, here in this Committee, called upon the NASD to lead a study examining the use of omnibus accounts.

Mr. GLAUBER. Indeed so.

Chairman SHELBY. Would you elaborate on the problems created by omnibus accounts and the end goal of the study.

Mr. GLAUBER. Certainly. The request came in conjunction with the study of the abuses of market timing, and the problem is this. In order to fully comprehend the abuses, it is necessary for investigators to be able to follow the trades of an individual investor, whether that is a person or, for example, a hedge fund. Omnibus accounts are a mechanism that brokerage firms use primarily to save money to aggregate trades from many investors into one aggregate account.

In that aggregation process, it makes it difficult to follow the trail of individual market-timing trades, and I think that is the reason the Chairman asked us to put together a task force to work on that, and we, of course, said we would, and we are in the process of doing that.

Chairman SHELBY. Thank you.

Attorney General Spitzer, one criticism of the global settlement was that the terms of the settlement permitted the firms involved

to seek insurance payments for all monies other than those payments designated as fines and penalties. Are you crafting settlements, and I guess I should ask Mr. Cutler this, are you crafting settlements that do not simply permit defendants to pass through their costs to insurance companies? In other words, they do not feel it if somebody else pays it, do they?

Mr. SPITZER. You are absolutely correct. If somebody can simply pass it through to an insurance carrier, then the fine/penalty is less painful—perhaps not painful at all.

Yes, we are very mindful of that as we move forward, and I would agree there were moments, as we look back on the global view of last year, that we wish we had been more refined in our language to prevent accessing insurance coverage to cover any of those costs. Frankly, it had been our view that under New York law that would not have been permitted.

We have learned perhaps otherwise these issues are still being litigated by the insurance company and the claimants, but certainly we are very mindful of that as we move forward, and we will endeavor to ensure that insurance does not cover the fines and penalties that are imposed.

Chairman SHELBY. Mr. Cutler.

Mr. CUTLER. Yes, I would echo Mr. Spitzer's comments. We certainly want to make sure that penalties are felt and that the sting of penalties is felt, and along those lines, penalties and fines should not be insurable.

Chairman SHELBY. Senator Sarbanes.

Senator SARBANES. Thank you very much, Mr. Chairman.

Mr. Glauber, I want to put this question to you, but I want to quote the Enforcement Director Cutler first. In testimony here in the Senate, before the Subcommittee over in the Government Operations Committee, at the beginning of the month, he said: "More than 25 percent—" that was of firms responding to an SEC mutual fund inquiry report "—said that customers have received 4 p.m. prices for orders placed or confirmed after 4 p.m. Fifty percent of responding fund groups appear to have had at least one arrangement allowing for market timing by an investor. Documents provided by almost 30 percent of responding brokerage firms indicate that they may have assisted market timers in some way such as by breaking up large orders or setting up special accounts to conceal their own or their clients' identities, a practice sometimes called 'cloning' to avoid detection by mutual funds that sought to prevent abuse of market timing."

"Almost 70 percent—70 percent—of responding brokerage firms reported being aware of timing activities by their customers."

Yet everyone, when they get asked about this, and we are not immune from it, I mean, we were constantly being told that everything was okay in the mutual fund industry; in fact, that it was unique to the—this arrived just in time. In a statement before the House Financial Services Committee, the Chairman of the ICI, Paul Haaga—this was in March of this year—said:

"The strict regulation that implements these objectives has allowed the industry to garner and maintain the confidence of investors and has also kept the industry free of the types of problems that have surfaced in other businesses in the recent past."

"An examination of several of the regulatory measures that have been adopted are under consideration to address problems that led to the massive corporate and accounting scandals of the past few years, provides a strong endorsement for the system under which mutual funds already operate."

Now there is an element of Claude Raines in "Casablanca" about all of this, that he is shocked to learn that gambling is taking place in the back room of Rick's casino. How do we explain this?

Some have said to us that it was an open secret that a lot of these practices were taking place. The trade group, the ICI, says, well, we did not know about it. In fact, they said they were, I think they actually used the word "shocked" to discover all of this, and now all of a sudden we are all operating on this premise—we were being told that everything was working very well, and now we are getting these incredible percentages here. There are not a few outriders engaging in this. It is very prevalent. How was all of this missed or what was happening?

Mr. GLAUBER. Well, first, as regards the issue of market timing and late trading, we have been cooperating with the SEC in doing investigations of member firms. We have had, in fact, a larger number, although they tend to be smaller member firms, and thus far we have referred 30 cases, from the 160 firms we have been looking at, to our Enforcement Division, dealing with just these issues.

How were they not seen? The fact is that market timing, the potential for market timing has been known for a long period of time. Indeed, the fund industry sought and put in place the so-called fair value pricing mechanisms a number of years ago, in principle, to deal with this. What was not understood is that in a number of cases, with favored customers, they were looking the other way.

And even perhaps more appalling, in cases inside the mutual funds themselves, portfolio managers were doing market timing and front-running their own customers or feeding, as the Chairman said in his introductory remarks, nonpublic information to favored customers.

The issue of market timing has been around for a long time, but the level of abuses, I think you are quite correct were just never evident in the way they are now becoming so.

Senator SARBANES. Mr. Cutler or Mr. Spitzer, do either of you have any theories?

Mr. SPITZER. Senator, if I could voice one general observation and one particular factual point. The general observation is that, over the last 2 years—I hate to say this—but my skepticism about the capacity of the SRO's to provide meaningful regulation has merely grown day-by-day as the magnitude and dramatic impact on investors of the abuses that ran rampant through the financial services industry have fallen out into the public's eye to observe.

I share the same concerns that you just articulated—given the rampant abuse that we have seen, the percentage numbers that are just staggering on the part of fund companies, how could it possibly not have been observed either in the regular examinations or elsewhere.

I would add one other data point, and this is a factual observation, there were, until quite recently, a very significant number of

hedge funds—very significantly capitalized hedge funds—that very openly stated that their strategy was one of market timing, mutual fund timing. There is nothing wrong, of course, for the hedge fund to participate in timing if it can get away with it. That observation, observing the number of prospectuses and offering documents——

Senator SARBANES. Well, there is nothing illegal about them doing that.

Mr. SPITZER. For the hedge fund.

Senator SARBANES. Yes.

Mr. SPITZER. The illegality in the——

Senator SARBANES. It may be wrong in terms of the impact it is having on the workings of the market and the ordinary investor.

Mr. SPITZER. Precisely. But for the hedge fund, there is nothing illegal about their trying to time the accounts. It is the burden that falls on the mutual fund because of its fiduciary duty to its shareholder. But anybody seeing the number of hedge funds whose prospectuses said we are going to be market timers, and the capital that was allocated to these hedge funds should have said, "Where is that money going? It is landing somewhere."

Senator SARBANES. I know that we are drawing to a close, Mr. Chairman.

Chairman SHELBY. That is okay. Go ahead.

Senator SARBANES. I want to just put a couple of quotes to you and get your reaction. One is Jack Bogle, the Vanguard founder, on November 14, in an op-ed piece in *The Wall Street Journal* said: There is a pervasive conflict between the interests of fund managers and fund shareholders that permeate the mutual fund industry and that the industry's bizarre structure has resulted in a total level of fund costs to investors that destroys any chance that the industry can provide to its fund shareholders their fair share of financial market returns."

Then because everyone now is focused on this, and we are getting lots of I think rather interesting observations, *Business Week,* in the November 17 issue, in an article entitled, "Funds Need a Radical New Design," said: "To retool fund governance to fit the reality of what the industry has become, Congress should scrap the fiction that each fund is a separate company. Instead, funds should be folded into the management company and funds and advisers should be under the authority of one board. That would give directors authority over managers, with the information, muscle, and responsibility to watch out for investors' interests."

I am interested in your reactions to these two comments. Mr. Glauber, why don't I start with you.

Mr. GLAUBER. I should start by saying, as you know, NASD's jurisdiction does not extend to the structure of funds, of mutual funds or the relationship with their management companies. Having said that, I think, at a minimum, there needs to be a strengthening of the governance structure as it now exists. And Chairman Donaldson, before this Committee earlier this week, proposed an increase in the number of independent directors and the proposal that the chairman be independent, and I think those are both very sensible proposals.

The *Business Week* notion is a very radically different approach to the whole governance structure of mutual funds, very different

from the 1940 Act. And it is one thing I think that Congress should consider. It is quite a radical change, and I think should be considered as one of a range of possible alternatives.

The first place I would look is where Chairman Donaldson talked about strengthening the structure that we have in place now.

Senator SARBANES. Mr. Cutler, do you want to add anything?

Mr. CUTLER. Sure. I guess I would say, first, that I do agree that conflict is endemic whenever you have someone managing someone else's money and getting paid for it. There is always going to be a conflict between the adviser and the advisee under those circumstances, and the question is how do you appropriately manage that conflict?

This is really not my bailiwick, the policy on where we go from here, but I guess one thing I would caution is that the conflict will not disappear just because you take the funds and the fund management company and collapse them. We will still have to be worried about that conflict, and it will still have to be managed, even if we do change the structure. I know that nothing is off the table, as far as Chairman Donaldson is concerned, but he has put forward, I think, some very, very powerful proposals on how we can do better in the area of managing those conflicts.

Senator SARBANES. Mr. Spitzer.

Mr. SPITZER. Yes, sir. The comment from Mr. Bogle is reminiscent of the comment that Paul Samuelson made several decades ago, when he looked at the 1940 Act structure and said, "The only place to invest, to make money in the mutual fund business was in the management companies," and he, from day one, said that is where they are going to be doing awfully well. Forget investing in the underlying shares—buy a management company. So, I think, for decades, people have observed this tension, and I think Jack Bogle is correct there, as he is in most cases.

In terms of the *Business Week* notion, I think it is certainly something that should be thought through. I have said to a number of your colleagues, sir, that I do not pretend right now, as we sit here, to have the answer or anything more than a few ideas that are based upon the investigations we have done, but certainly, based upon what we have seen, this fiction, as *Business Week* called it, that there needs to be a division between the board and the management company is a fiction that does appear to be increasingly useless and raise the possibility that collapsing the two would be a sensible move as we restructure governance.

Senator SARBANES. Mr. Chairman, I know that you are drawing the hearing to a close. I just want to thank our panel, and I just want to say that, gentlemen, each of you is on the front line, as far as this is concerned. If the American investor were to ask us, "Who are our champions? Who is there to be our gatekeepers and try to protect us in the current situation," it would be the people at the table.

So, we encourage you on in your efforts. We appreciate what you are doing. I know there is a great deal of pressure and stress, and I know these offices are working to capacity or beyond capacity in terms of the demands they are making on their staff, but we appreciate what you are doing, and we encourage you to keep at it. That is the parting word I want to leave with you.

Thank you.

Chairman SHELBY. I want to associate myself with Senator Sarbanes' remarks. You are on the front line, all three of you, and the American investor is looking for relief. They are looking for honest markets, and we are greatly challenged. And if we are greatly challenged, you are greatly challenged, but I think you are up to the challenge if we back you, and we will.

Senator Sarbanes and I are committed to more hearings to find out what is the answer to this, from a regulatory standpoint, or perhaps a legislative standpoint. We do not want to rush to judgment in the waning days of a Congressional session. We might have you back, as we have had Chairman Donaldson.

We thank you for your appearance, and we thank you for what you share with us.

Thank you.

[Whereupon, at 3:59 p.m., the hearing was adjourned.]

[Prepared statements and additional material supplied for the record follow:]

PREPARED STATEMENT OF STEPHEN M. CUTLER

DIRECTOR, DIVISION OF ENFORCEMENT
U.S. SECURITIES AND EXCHANGE COMMISSION

NOVEMBER 20, 2003

Introduction

Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee, thank you very much for inviting me to testify today on behalf of the Securities and Exchange Commission concerning alleged abuses relating to the sale of mutual funds. With more than 95 million Americans invested in mutual funds, representing approximately 54 million U.S. households, and a combined $7 trillion in assets, mutual funds are a vital part of this Nation's economy and millions of investors' financial security. For that reason, I share the outrage and disappointment of the Commission, Chairman Donaldson, the investing public, and so many others, at the misconduct that recently has come to light. It is intolerable when investment professionals—who have a duty to serve the best interests of their customers—instead put their own interests first. That way of thinking is antithetical to the responsibilities investment advisers, broker-dealers, and their employees owe to mutual fund investors. Mutual fund investors have a right to expect fair treatment, and when they do not receive it, we at the Commission will demand it on their behalf.

Accordingly, the Commission has undertaken an aggressive agenda to identify and address problems in the mutual fund industry. That agenda has both an enforcement component, which I will discuss, and a regulatory component, which Chairman Donaldson discussed in his testimony before this Committee 2 days ago.

The enforcement piece of the Commission's agenda relating to mutual funds currently is focused primarily on four types of misconduct, each of which may result in the interests of financial services firms or their employees being placed above the interests of investors. I will touch on each briefly, and then turn to the Commission's response to the recent revelations of serious misconduct relating to the trading of mutual funds.

The first area of priority, which I will discuss in detail in a moment, is late trading and timing of mutual fund shares.

Our second area of priority focuses on fee disclosure issues in connection with the sale of mutual funds. In particular, we are looking at what prospective mutual fund investors are—or are not—being told about revenue sharing arrangements and other incentives doled out by mutual fund companies to brokers selling their funds. Do customers understand that their broker is being paid to sell a particular fund? And when these payments are being made from fund assets, do customers understand that their own investment dollars are being used to foot the bill for the mutual funds' premium "shelf space" at the selling broker's office? Such fees may increase costs to investors, as well as create conflicts of interest between investors and the financial professionals with whom they deal.

The Commission brought its first case in this area earlier this week. In that action, against Morgan Stanley DW (Morgan Stanley), the Commission found that the firm had not adequately disclosed that certain mutual funds Morgan Stanley offered to its customers were part of something it called the "Partners Program." Under the Partners Program, a select group of mutual fund families paid Morgan Stanley substantial fees for preferred marketing of their funds. To incentivize its sales force to deliver the preferred marketing Morgan Stanley promised its partners, Morgan Stanley paid increased compensation to individual registered representatives and branch managers on sales of those funds' shares. But when Morgan Stanley's customers purchased the preferred mutual funds, they were not told about the Partners Program, and were therefore not in a position to understand the nature and extent of the conflicts of interest that may have affected their transactions. The Commission found Morgan Stanley also made inadequate disclosures in a second area, which I will discuss in a moment.

Morgan Stanley agreed to settle this action by paying $25 million in disgorgement and prejudgment interest, and civil penalties totaling $25 million. All $50 million will be placed in a Fair Fund under the Sarbanes-Oxley Act and will be returned to investors. In addition, Morgan Stanley has undertaken to, among other things, place on its website disclosures regarding the Partners Program and provide customers with a disclosure document that will disclose specific information concerning the Partners Program.

The abuses that are addressed in this case are significant and are not necessarily limited to Morgan Stanley. So-called shelf space payments have become popular with brokerage firms and the funds they are selling. Thus, the Commission is conducting an examination sweep of some 15 different broker-dealers to determine ex-

actly what payments are being made by funds, the form of those payments, the "shelf space" benefits that broker-dealers provide, and most importantly, just what these firms tell their investors about these practices.

The potential disclosure failures and breaches of trust spotlighted in the Morgan Stanley case are not limited to broker-dealers. We are also looking very closely at the role of mutual fund companies themselves. In that regard, I want to return to and finish with a point that I alluded to earlier. The aspect of the Morgan Stanley case that I find perhaps most troubling is this: Morgan Stanley said to the fund families that are part of the Partners Program: "You can pay us in one of two ways—either the fund management company can pay us in cash; or the mutual funds you manage can defray the fund management company's obligation by giving us a multiple of that amount in the form of extra commission business on fund portfolio transactions." Faced with that choice, some fund companies—rather than reaching into their own pocket to pay what they owed—reached into the pockets of their mutual fund shareholders and paid in commission dollars instead. You can be certain that we are pursuing that issue, among others, as our investigation continues, and our exam sweep goes forward.

Our third area of priority in the mutual fund arena is the sale of different classes of mutual fund shares. Many mutual funds offer multiple classes of shares in a single portfolio. For each class of shares, a mutual fund uses a different method to collect sales charges from investors. Class A fund shares are subject to an initial sales charge (front-end load); discounts on front-end loads are available for large purchases of Class A shares. Since the sales fee is paid up front, Class A shares incur lower (or no) "Rule 12b–1 fees," fees the mutual fund pays for distribution costs, including payments to the broker-dealers and their registered representatives selling fund shares.

Class B shares, by contrast, are not subject to an up-front sales charge. Instead, they become subject to a sales charge (a "contingent deferred sales charge" or "CDSC") only if they are redeemed before the end of a specified holding period. Because Class B share investors do not pay an up-front sales fee, the funds pay higher Rule 12b–1 fees on Class B shares to defray the associated distribution expenses. As a result, brokers typically earn larger payments on Class B shares than on Class A shares. In addition, long-term mutual fund shareholders may pay higher sales charges if they hold B shares rather than A shares, particularly when discounts, as discussed below, are available on the A shares.

The Commission has brought three enforcement actions involving the sales of Class B shares to investors who were not made aware by their registered representatives that they could purchase Class A shares of the same mutual fund at a discount (sometimes called a "breakpoint" discount). Indeed, in this week's Morgan Stanley case, the Commission found that Morgan Stanley's disclosures to customers concerning B shares were inadequate. To address this violation, the relief we obtained in this case includes an agreement by Morgan Stanley to convert to Class A shares and otherwise make whole those customers who would have been entitled to a breakpoint discount had they purchased A shares in the first place. In addition, Morgan Stanley has agreed to retain an independent consultant to conduct a review of, and to provide recommendations concerning, its disclosures, policies, and procedures and its plan to offer to convert Class B shares to A shares. The firm is required to adopt the recommendations of the independent consultant.

Earlier this year, the Commission brought an action against Prudential Securities for abuses in this area as well. In that case, filed in July, the Commission found that Prudential's supervisory system for overseeing practices in this area were inadequate. Prudential had in place policies and procedures requiring registered representatives to advise their clients of the availability of different classes of mutual funds and fully explain the terms of each. Prudential branch managers were also expected to approve all purchases greater than $100,000 and confirm the suitability of the choice of fund class. The Commission found, however, that Prudential failed to adopt a sufficient supervisory system to enable those above the branch manager to determine whether these policies and procedures were being followed. Under Prudential's system, branch office managers were solely responsible for ensuring that registered representatives followed the firm's mutual fund policies and procedures. As a result, when the registered representatives' branch manager failed to abide by and enforce Prudential's policies and procedures, the firm had no way of detecting the lapse. In resolving the Commission's action, Prudential was censured and agreed to pay disgorgement and a civil penalty. The Commission's action against the registered representative and branch manager, which charges them with fraud, is pending.

The fourth priority area is to address the failure of firms to give their customers the discounts available on front-end loads for large purchases of Class A shares.

Earlier this year, examiners at the SEC, NASD, and NYSE completed an examination sweep and outlined the results in a report, "Joint SEC/NASD/NYSE Report of Examinations of Broker-Dealers Regarding Discounts on Front-End Sales Charges on Mutual Funds."[1] Together with the NASD, we have under active investigation instances in which it appears that investors were entitled to receive breakpoint discounts based on the size of their purchase of Class A shares, but where the firms failed to provide discounts.

Before I turn to abuses that have more recently come to light, I will mention two types of misconduct, harmful to mutual fund investors, where the Commission has both an active and aggressive track record and a roster of current investigations. The first is the area of fund disclosures concerning the effect of hot IPO shares on fund performance; the second is pricing and valuation practices of mutual funds.

The Commission has brought three actions in the last several years charging registered investment advisers with failing to disclose the substantial positive effect that holding or trading hot IPO shares had on their funds' performance, and, critically, the risk that such exceptional performance could not be sustained. In one case, the investment adviser also did not disclose that a portfolio manager, who managed multiple mutual funds, allocated securities purchased in initial public offerings—especially "hot" IPO's—in a manner that had the overall effect of favoring one fund over three others he managed. The adviser did not disclose this practice, notwithstanding the fund's prospectus disclosure that investment opportunities would be allocated equitably among the fund complex's funds.

These cases are an unfortunate part of an all-too-common theme—mutual funds and their advisers often are reluctant or unwilling to disclose to investors important performance-related information to which they are not only entitled, but which they must have in order to make fair and reasoned investment decisions. With respect to valuation, the problem more typically is a failure on the part of funds and their advisers to *adhere* to the policies and procedures that they *have* disclosed. We are actively looking at two situations in which funds dramatically wrote down their Net Asset Values in a manner that raises serious questions about the funds' pricing methodologies.

This brief overview of the Commission's enforcement agenda with respect to mutual funds is intended to give you a sense of the scope of our activities. I recognize, however, that today's hearing was prompted by recent revelations involving late trading and timing of mutual funds. Accordingly, I will now turn to that subject.

SEC Response to Misconduct Relating to Mutual Funds

As you well know, the conduct of mutual funds and the financial intermediaries with and through which they do business, recently came to the public's attention when New York Attorney General Eliot Spitzer announced an action involving abusive mutual fund trading practices by a hedge fund, Canary Capital Partners, LLC. The Canary action identified two problematic practices—late trading of mutual funds and timing of mutual funds. Late trading refers to the practice of placing orders to buy or sell mutual fund shares after the time at which the funds calculate their net asset value (NAV)—typically 4 p.m. Eastern Time (ET)—but receiving the price based upon the prior NAV already determined as of 4 p.m. Late trading violates a provision of the Federal securities laws that dictates the price at which mutual fund shares must be bought or sold and defrauds innocent investors in those mutual funds by giving to the late trader an advantage not available to any other investors.

"Timing" abuses refer to excessive short-term trading in mutual funds in order to exploit inefficiencies in mutual fund pricing. Although market timing itself is not illegal, mutual fund advisers have an obligation to ensure that mutual fund shareholders are treated fairly, and they should not favor one group of shareholders (i.e., market timers) over another group of shareholders (i.e., long-term investors). In addition, when a fund states in its prospectus that it will act to curb market timing, it must meet that obligation.

Abusive market timing can dilute the value of mutual fund shares to the extent that a trader may buy and sell shares rapidly and repeatedly to take advantage of inefficiencies in the way mutual funds prices are determined. Dilution could occur if fund shares are overpriced and redeeming shareholders receive proceeds based on the overvalued shares. In addition, short-term trading can raise transaction costs for the fund, it can disrupt the fund's stated portfolio management strategy, require a fund to maintain an elevated cash position, and result in lost opportunity costs and forced liquidations. Short-term trading can also result in unwanted taxable capital gains for fund shareholders and reduce the fund's long-term performance. In

[1] The report is available at: *http://www.sec.gov/news/studies/breakpointrep.htm.*

short, while individual shareholders may profit from engaging in short-term trading of mutual fund shares, the costs associated with such trading are borne by all fund shareholders.

Following the announcement of the Canary Capital case, the Commission put in motion an action plan to vigorously investigate the matter, assess the scope of the problem, and hold any wrongdoers accountable. Specifically, the Commission is proceeding on three fronts, utilizing its enforcement authority, its examination authority, and its regulatory authority. I will address the first two areas of the Commission's efforts.

Recent Enforcement Efforts Relating to Mutual Fund Trading

In the enforcement area, we are working aggressively to pursue wrongdoing, and are doing so in coordination with State regulators. Thus far, the Commission has brought actions against persons associated with three different types of entities—broker-dealers, hedge funds, and mutual funds—each of which can play a role in harming long-term mutual fund investors. Our actions to date address allegations of both late trading and market timing. I will briefly summarize those actions.

On September 16, the Commission filed a civil action against Theodore Sihpol, a salesperson at Bank of America Securities (BOA), who was Canary Capital's primary contact at Bank of America. Specifically, the Commission issued an administrative order instituting proceedings in which the Division of Enforcement (the Division) alleges that Sihpol played a key role in enabling certain hedge fund customers of BOA to engage in late trading in shares of mutual funds offered by Bank of America, including the Nations Funds family of funds and other mutual funds. Based on the conduct alleged in the Commission's Order, the Division alleges that Sihpol violated, and aided and abetted and caused violations of, the antifraud, mutual fund pricing and broker-dealer record-keeping provisions of the Federal securities laws. In its action, the Division is seeking civil penalties, disgorgement, and other relief, which may include permanently barring Sihpol from the securities industry.[2] Simultaneous with the issuance of the Commission's order, Sihpol surrendered in connection with Attorney General Spitzer's filing of a two-count complaint charging him with larceny and securities fraud.

Less than 3 weeks later, the Commission and the New York Attorney General announced criminal and civil actions against Steven B. Markovitz, formerly an executive and senior trader with the prominent hedge fund firm Millennium Partners, LP. In the New York Attorney General's criminal action, Markovitz pleaded guilty in State Supreme Court to a violation of New York's Martin Act. The SEC's administrative order finds that Markovitz committed securities fraud. In partial settlement of the SEC's action, without admitting or denying the SEC's findings, Markovitz consented to cease and desist from violations of certain provisions of the Federal securities laws, and to be permanently barred from associating with an investment adviser or from working in any capacity with or for a registered investment company. The SEC also is seeking disgorgement and civil penalties in amounts to be determined later.

According to the criminal charges and the SEC findings, Markovitz engaged in late trading of mutual fund shares on behalf of Millennium, one of the Nation's largest hedge fund operators, with more than $4 billion under management. With the assistance of certain registered broker-dealers, Markovitz placed mutual fund orders after 4 p.m. ET, but obtained the prices that had been set as of 4 p.m. ET. By SEC rule, Markovitz's post-4 p.m. orders should have received the prices set on the following day. This illegal trading allowed Millenium to take advantage of events that occurred after the markets closed.

In its first action against a mutual fund executive for permitting market timing, on October 16, the Commission and the New York Attorney General announced the arrest, conviction, and lifetime industry bar of James P. Connelly, Jr., former Vice Chairman and Chief Mutual Fund Officer of Fred Alger & Company, Inc., a prominent mutual fund firm. Connelly pled guilty to the crime of Tampering with Physical Evidence. The criminal charges against Connelly stem from his repeated efforts to tamper with an ongoing investigation of illegal trading practices in the mutual fund industry, including by directing subordinates to delete emails called for by subpoenas.

In its administrative order, the SEC found that Connelly approved agreements that permitted select investors to "time" certain mutual funds managed by Alger, a practice that violates an adviser's fiduciary duties and adversely affects the value

[2] In connection with the SEC's order, a hearing will be scheduled before an administrative law judge to determine whether the allegations contained in the order are true and to provide Sihpol an opportunity to respond to them.

of the fund being timed. In this case, the timing arrangements were also inconsistent with Alger's public disclosures in prospectuses and Statements of Additional Information filed with the SEC. According to the Commission's order, Connelly was involved in timing arrangements at Alger from the mid-1990's until 2003. By early 2003, Connelly was requiring that investors seeking timing capacity agree to maintain at least 20 percent of their investment at Alger in buy-and-hold positions, sometimes referred to as "sticky assets."

Connelly has been ordered to cease and desist from future violations of various provisions of the Federal securities laws; has been barred from association with any broker, dealer, or investment adviser; has been barred from serving in various capacities with respect to any registered investment company; and is subject to a $400,000 civil penalty.

On October 28, the Commission brought actions against Putnam Investment Management LLC (Putnam) and two former Putnam Managing Directors and portfolio managers, Justin M. Scott and Omid Kamshad, in connection with the personal trading by those Managing Directors in Putnam mutual funds. The Commission filed a civil injunctive action against Justin M. Scott and Omid Kamshad charging each of them with securities fraud. The complaint alleges that Scott and Kamshad, for their own personal accounts, engaged in excessive short-term trading of Putnam mutual funds for which they were portfolio managers. According to the complaint, Scott and Kamshad's investment decisionmaking responsibility for those funds afforded them access to nonpublic information about the funds, including current portfolio holdings, valuations, and transactions. The complaint further alleges that Scott and Kamshad's short-term trading violated their responsibilities to other fund shareholders, that Scott and Kamshad failed to disclose their trading and that, by their trading, they potentially harmed other fund shareholders. In this action, the Commission is seeking injunctive relief, disgorgement, penalties, and such equitable relief as the court deems appropriate.

The Commission also issued an administrative order instituting proceedings against Putnam. Subsequently, on November 13, the Commission issued another order against Putnam reflecting a partial settlement with the firm. In connection with that agreement, Putnam committed to undertake significant and far-reaching reforms relating to excessive short-term and market timing trading by its employees. Putnam also agreed to a process for calculating and paying restitution to investors. The amount of civil penalty and other monetary relief to be paid by Putnam remains open and will be determined at a later date.

In its Order against Putnam, the Commission found that Putnam committed securities fraud by failing to disclose potentially self-dealing securities trading by several of its employees. The Commission also found that Putnam failed to take adequate steps to detect and deter such trading activity through its own internal controls and its supervision of investment management professionals. Putnam has agreed to admit these findings for purposes of the penalty phase of the administrative proceeding, which has not yet taken place.

The reforms that Putnam agreed to implement, pursuant to the Commission's Order, are all designed to prevent the violations found by the Commission. They can be broken down into three important areas: (1) restrictions on employee trading; (2) enhancements of compliance policies, procedures, and staffing, including relating to employee trading; and (3) corporate governance, including fund board independence.

Among the reforms Putnam will implement relating specifically to employee trading is a requirement that employees who invest in Putnam funds hold those investments for at least 90 days, and in some cases, as long as 1 year.

In the compliance area, Putnam will:

- Require Putnam's Chief Compliance Officer to report to the fund boards' independent trustees all breaches of fiduciary duty and violations of the Federal securities laws.
- Maintain a Code of Ethics Oversight Committee to review violations of the Code of Ethics and report breaches to the fund boards of trustees.
- Create an Internal Compliance Controls Committee to review compliance controls and report to the fund boards of trustees on compliance matters.
- Retain an Independent Compliance Consultant to review Putnam's policies and procedures designed to prevent and to detect breaches of fiduciary duty, breaches of the Code of Ethics, and Federal securities law violations by Putnam and its employees.
- At least once every 2 years, Putnam will have an independent, third-party conduct a review of the firm's supervisory, compliance and other policies and procedures in connection with the firm's duties and activities on behalf of and related to the Putnam funds.

In the area of corporate governance, Putnam agreed:

- That the fund boards of trustees will have an independent chairman.
- That the fund boards of trustees will consist of at least 75 percent independent members.
- That no board action may be taken without approval by a majority of the independent directors; and that Putnam will make annual disclosure to fund shareholders of any action approved by a majority of the fund board's independent trustees, but not approved by the full board.
- That the fund boards of trustees will hold elections at least once every 5 years, starting in 2004.
- That the fund boards of trustees will have their own, independent staff member who will report to and assist the fund boards in monitoring Putnam's compliance with the Federal securities laws, its fiduciary duties to shareholders, and its Code of Ethics.

In sum, the reforms Putnam will undertake as part of the Commission's order are intended to provide real, substantial, and *immediate* protections for mutual fund investors. The required enhancements to the board oversight and compliance functions at Putnam should strengthen *all* aspects of Putnam's fund operations and provide investors with uncompromised representation by their fiduciaries in the boardroom and at the management company. In addition, the Division of Enforcement fully intends to seek substantial penalties and/or other monetary payments from Putnam, over and above the restitution Putnam already is bound by the Commission's order to make. And, of course, the Commission's investigation of Putnam and its employees is active and ongoing. If additional misconduct comes to light, the Commission will bring additional enforcement actions.

On November 4, in conjunction with the Secretary of the Commonwealth of Massachusetts, the Commission announced still another enforcement action, this one against five Prudential Securities brokers and their branch manager. The Commission alleged in a civil action that the defendants defrauded mutual funds by misrepresenting or concealing their own identities or the identities of their customers so as to avoid detection by the funds' market timing police. This allowed them to enter thousands of market timing transactions after the funds had restricted or blocked the defendants or their customers from further trading in their funds. The Commission is seeking injunctive relief, disgorgement, penalties, and such equitable relief as the court deems appropriate.

The Commission's Use of Examination Authority

As I noted, the Commission's response to the revelations of misconduct in the mutual fund area is multipronged. The second area of authority that we are utilizing aggressively is the Commission's examination authority, which entitles us to obtain promptly information and records from regulated entities. Accordingly, immediately following the Canary announcement, relying on the Commission's examination powers, the Commission's staff sent detailed requests for information and documents to 88 of the largest mutual fund complexes in the country and 34 broker-dealers, including prime brokerage firms and other large broker-dealers. These written requests sought information on each entity's policies and practices relating to market timing and late trading. In the case of mutual funds and broker-dealers, we have obtained information regarding their pricing of mutual fund orders and adherence to their stated policies regarding market timing. We also have sought information from mutual funds susceptible to market timing regarding their use of fair value pricing procedures to combat this type of activity.

The examination staff is still analyzing the information received as a result of these requests, and in many cases has sought additional details. Nevertheless, some firms' responses have warranted aggressive follow-up, and thus, the Commission examiners have been dispatched to conduct onsite inspections and interviews at a number of firms. Responses from some other firms have already led to referrals to the enforcement staff for further investigation. All told, SEC staff across the country are looking at the activities and practices of dozens of mutual fund and broker-dealer firms.

As I noted earlier, the Commission's examination and enforcement staff are examining and investigating other industry practices, such as the sale of B shares to investors, payments for "shelf space," and the failure to give breakpoint discounts.

Conclusion

The Commission's investigations of mutual fund trading and sales practices abuses are continuing on multiple fronts. I want to emphasize that we will aggressively pursue those who have violated the law and injured investors as a result of sales practice and related disclosure abuses, failure to give breakpoint discounts,

improper valuation practices, illegal late-trading, market-timing, self-dealing, or any other illegal activity we uncover. Those responsible for these practices will be identified and will be held fully accountable.

Wherever possible, the Commission also will seek recompense for investors in connection with mutual fund fraud. We will, of course, continue to work closely and cooperatively with State officials who also are taking steps to protect investors.

I would be happy to answer any questions that you may have.

PREPARED STATEMENT OF ROBERT R. GLAUBER

CHAIRMAN AND CHIEF EXECUTIVE OFFICER
NATIONAL ASSOCIATION OF SECURITIES DEALERS

NOVEMBER 20, 2003

Mr. Chairman and Members of the Committee, NASD would like to thank the Committee for the invitation to submit this written statement for the record.

NASD

NASD, the world's largest securities self-regulatory organization, was established in 1939 under the authority granted by the 1938 Maloney Act Amendments to the Securities Exchange Act of 1934. Every broker-dealer in the United States that conducts a securities business with the public is required by law to be a member of NASD. NASD's jurisdiction covers nearly 5,400 securities firms that operate more than 92,000 branch offices and employ more than 665,000 registered securities representatives.

NASD writes rules that govern the behavior of securities firms, examines those firms for compliance with NASD rules, MSRB rules, and the Federal securities laws, and disciplines those who fail to comply. Last year, for example, we filed a record number of new enforcement actions (1,271) and barred or suspended more individuals from the securities industry than ever before (814). Our investor protection and market integrity responsibilities include examination, rulewriting and interpretation, professional training, licensing and registration, investigation and enforcement, dispute resolution, and investor education. We monitor all trading on the Nasdaq Stock Market—more than 70 million orders, quotes, and trades per day. NASD has a nationwide staff of more than 2,000 and is governed by a Board of Governors at least half of whom are unaffiliated with the securities industry.

NASD's involvement with mutual funds is predicated on our authority to regulate broker-dealers. NASD does not have any jurisdiction over investment companies or the fund's investment adviser; rather, we regulate the sales practices of broker-dealers who sell the funds to investors. Our investor education efforts also place special emphasis on mutual funds due to their widespread popularity with investors.

The behavior that has been uncovered in the mutual fund industry has been reprehensible. The mutual fund industry was for years an example of a clean, disciplined industry. This reputation helped to foster growth in these products that offered investors relatively low-cost professional management, diversification, and risk control to fit a wide range of investor needs. But now the industry has seriously undermined investor trust with a wide range of abuses—portfolio managers trading ahead of mutual fund investors, differential release of portfolio information, deals with preferred customers to permit market timing trades. Broker participation in illegal or unethical sales practices is very much a direct concern of NASD.

Disclosure

This week during testimony before this Committee, Securities and Exchange Commission (SEC) Chairman Donaldson discussed a series of reforms in the realm of disclosure that he intends to seek. NASD supports these SEC efforts. Investors deserve clear and easy-to-read disclosure that tells them of all the costs associated with their mutual funds. Not just the load and fees that affect investor costs but also the other arrangements that affect the price—including Commission expenses and compensation arrangements between the broker and the fund. One of the bedrock principles of our free market system is that all participants have access to information about prices and costs that can influence their decisions. When this information is hidden or distorted, buyers are not able to make the best decisions about where to invest their money.

In August, NASD proposed greatly expanded disclosure of mutual fund compensation arrangements. The proposal is designed to alert investors to the financial incentives that a brokerage firm or its registered representatives may have to recommend particular funds.

The proposal would ensure that investors receive timely information about two types of compensation arrangements. The first consists of cash payments by fund sponsors to broker-dealers to induce fund sales. Typically, these payments are made in order to gain "shelf space" at the broker, or to secure a place for a fund on a preferred sales list. The second is the payment by a broker-dealer of a higher compensation rate to its own registered representatives for selling certain funds. The proposal would require firms to disclose these compensation arrangements in writing when the customer first opens an account or purchases mutual fund shares. The proposal also would require member firms to update this information twice a year and make it available on their websites, through a toll-free number, or in writing.

The comment period on the proposal ended October 17, 2003. NASD has received approximately 40 comment letters on the proposal, which the staff is reviewing.

Recent Enforcement Efforts and Rule 2830

To combat abuses in the realm of our regulatory authority, we have concentrated our examination and enforcement focus on five main areas: First, cash and noncash compensation practices and arrangements; second, the suitability of the mutual funds that brokers are selling, in particular B share abuses; third, whether brokers are delivering to their customers the benefits to which they are entitled, such as breakpoint discounts; and finally, market timing and late trading. All told, we have brought some 60 enforcement cases this year in the mutual fund area, and more than 200 over the last 3 years. We also have a large number of ongoing examinations and investigations involving these and other mutual fund issues.

Cash and Non-Cash Compensation Practices and Arrangements

Just this week, NASD announced an enforcement action against Morgan Stanley for giving preferential treatment to certain mutual fund companies in return for millions of dollars in brokerage commissions. This is the second action brought by NASD against Morgan Stanley for mutual fund violations in the last 2 months and is part of our broader effort to crack down on sales practice abuses. In conjunction with a related action filed by the SEC, Morgan Stanley agreed to resolve the NASD and SEC actions by paying $50 million in civil penalties and surrendered profits, all of which will be returned to injured investors.

In the Morgan Stanley case, NASD found that from January 2000 until 2003, Morgan Stanley operated two programs which gave favorable treatment to products offered by as many as 16 mutual fund companies out of a total of over 115 fund complexes that could be sold by the firm's sales force. In return for these brokerage commissions and other payments, mutual fund companies received preferential treatment by Morgan Stanley, which included:

- Placement on a "preferred list" of funds that financial advisors were to look to first in making recommendations of fund products.
- Higher visibility on Morgan Stanley's sales systems and workstations than non-paying funds.
- Eligibility to participate in the firm's 401(k) programs and to offer offshore fund products to Morgan Stanley customers.
- Better access to its sales force and branch managers.
- Payment of special sales incentives to Morgan Stanley financial advisors.

In addition, the participating mutual fund companies paid Morgan Stanley an extra 15 to 20 basis points on each sale. This was over and above the normal fees earned by the firm for selling the funds.

This extra compensation paid to Morgan Stanley for the preferential treatment included millions of dollars paid by the mutual funds through commissions charged by the firm for trades it executed for the funds. These commissions were sufficiently large to pay for the special treatment, as well as the costs of trade execution. This conduct violated NASD's Conduct Rule 2830(k), one important purpose of which is to help eliminate conflicts of interest in the sale of mutual funds.

NASD is also conducting an examination sweep where we are looking at more than a dozen broker-dealers, specifically with a view to determine how investment companies pay for inclusion on firms' featured mutual fund lists or why they receive favored promotional or selling efforts. Thousands of funds are presented to investors through discount and online broker-dealer "supermarkets." We are looking at different types of firms, including full-service, discount, and online broker-dealers. In addition, we are examining a similar number of mutual fund distributors, who are also our members. Mutual fund sponsors and distributors that once marketed exclusively through a single, traditional distribution channel often now compete head-to-head in the same distribution channels vying for visibility and valuable "shelf space." We want to see what the distributors' role may be in these types of practices.

As demonstrated in the recent case against Morgan Stanley, exchanging prominent placement of a fund or a family of funds on a firm's website or in the firm's marketing material or placing a fund on a "featured" or "preferred" list of funds in exchange for brokerage commissions from the funds constitutes a violation of the NASD rules.

Another section of NASD Conduct Rule 2830 prohibits the award of noncash compensation, such as lavish trips and entertainment, to brokers for the sale of mutual fund shares. In September, we brought another case against Morgan Stanley that resulted in a $2 million fine against the firm. Morgan Stanley conducted prohibited sales contests for its brokers and managers to push the sale of Morgan Stanley's own proprietary mutual funds. In addition to censuring and fining the firm, NASD also censured and fined a senior member of the firm's management—the head of retail sales.

Between October 1999 and December 2002, the firm had conducted 29 contests and offered or awarded various forms of noncash compensation to the winners, including tickets to Britney Spears and Rolling Stones concerts, tickets to the NBA finals, tuition for a high-performance automobile racing school, and trips to resorts.

The obvious danger of such contests is that they give firm personnel a powerful incentive to recommend products that serve the broker's interest in receiving valuable prizes, rather than the investment needs of the customer. And one of the most troubling things about this case is Morgan Stanley's failure to have any systems or procedures in place that could detect or deter the misconduct.

In January 2003, NASD censured and fined IF Distributor, Inc., and VESTAX Securities Corp. a total of $150,000 for failing to disclose special cash compensation they paid to their sales force in the sale of mutual fund shares. Prior to disclosing this special cash compensation, the brokers sold over $20 million in Class A shares to over 200 customers. Brokers selling these shares received approximately $220,000 in special cash compensation.

Suitability of Mutual Fund Sales—Class B Shares

Many mutual funds offer different classes of the same investment portfolio. Each class is designed to provide brokers and their customers with a choice of fee structure. Class A mutual fund shares charge a sales load when the customer purchases shares. Class B shares do not impose such a sales charge. Instead, Class B shares typically impose higher expenses that investors are assessed over the lifetime of their investment. Class B shares also normally impose a contingent deferred sales charge (CDSC), which a customer pays if the customer sells the shares within a certain number of years. In addition, investors who purchase Class B shares cannot take advantage of breakpoint discounts available on large purchases of Class A shares.

NASD has found that some brokers have unscrupulously recommended Class B shares in such large amounts that the customer would have qualified for breakpoint discounts had the broker recommended Class A shares instead. In this instance, the broker may receive higher compensation for the Class B recommendations. NASD has vigorously prosecuted these violations, and we are continuing a comprehensive review of Class B shares sales practices. Over the last 2 years, NASD has brought more than a dozen enforcement actions against firms and individual brokers for these types of violations. Presently, we have more than 50 open and active investigations in this area.

For example, in May the SEC affirmed a disciplinary action NASD took against Wendell D. Belden, who was found to have violated NASD's suitability rule by recommending that a customer purchase Class B mutual fund shares in five different mutual funds within two fund families instead of Class A mutual fund shares. Because of the size of his customer's investment ($2.1 million) and the availability of breakpoint discounts for Class A shares, Belden's recommendations caused his customer to incur higher costs, including contingent deferred sales charges.

Belden tried to justify his recommendations to customers that they purchase the Class B shares instead of the Class A shares because he received greater commissions on the sales of these shares. He stated that he "could not stay in business" with lower commissions. Belden was fined, suspended, and ordered to pay more than $50,000 back to his customers.

In June, we announced a settled action against McLaughlin, Piven, Vogel for violations in this area. The firm was fined $100,000 and ordered to pay restitution of approximately $90,000 to 21 customers. In August, we announced five more actions for unsuitable sales of Class B shares.

Breakpoint Discounts

Mutual funds typically offer discounts to the front-end sales load assessed on Class A shares at certain predetermined levels of investment, which are called "breakpoints." The extent of the discount is based on the dollar size of the investor's investment in the mutual fund. For example, breakpoint discounts may begin at dollar levels of $25,000 (although, more typically, at $50,000) and increase at $100,000, $250,000, $500,000, and $1,000,000. At each higher level of investment, the discount increases, until the sales charge is eliminated.

An investor can become entitled to a breakpoint discount to the front-end sales charge in a number of ways. First, an investor is entitled to a breakpoint discount if his single purchase is equal to or exceeds the specified "breakpoint" threshold. Second, mutual funds generally allow investors to count future purchases toward achieving a breakpoint if the investor executes a letter of intent that obligates him to purchase a specified amount of fund shares in the same fund or fund family within a defined period of time. Similarly, mutual funds generally grant investors "rights of accumulation," which allow investors to aggregate their own prior purchases and the holdings of certain related parties toward achieving the breakpoint investment thresholds (including reaching investment thresholds necessary to satisfy letters of intent).

Mutual fund families began to offer these breakpoint discounts to make their funds more attractive to investors. Over time, funds expanded the rights of accumulation they offered by expanding the categories of accounts that could be linked or aggregated for the purpose of obtaining breakpoint discounts. Mutual funds view their aggregation rules as important competitive features of their products. Accordingly, these rights of accumulation can vary from fund family to fund family, and many fund families define the related parties that can aggregate their holdings to determine breakpoint discount eligibility differently. For instance, one fund family may allow parents to link their accounts with a "minor child," while another fund family may allow parents to link their accounts with any child residing at home.

During routine examinations of broker-dealers by our Philadelphia District Office, NASD discovered that broker-dealers selling front-end load mutual funds were not properly delivering breakpoint discounts to investors. Following this discovery, in November and December 2002, the SEC and the New York Stock Exchange joined us for an examination sweep of 43 firms selling front-end load mutual funds. We found that most of those firms did not give investors all the breakpoint discounts they should. Failures to give the discounts stemmed from a variety of different operational problems, including a failure to link share classes and holdings in other funds in the same fund family and a failure to link accounts of family members.

NASD issued a *Notice to Members* on December 23, 2002, reminding firms to explain and deliver breakpoints. And we issued in January 2003, an Investor Alert to advise customers of breakpoint opportunities.

Also in January 2003, the SEC asked NASD to lead a task force to find breakpoint solutions. The task force had 24 members, including representatives from broker-dealers, mutual funds, transfer agents, clearing facilities, academia, the SEC staff, other SRO's, and trade associations.

The Task Force issued its report in July 2003, in which it recommended a number of technological and operational changes, as well as modifications to mutual fund prospectus and other disclosure and sales practices, to ensure that customers are not overcharged. Working groups, consisting of knowledgeable representatives of the mutual fund and securities industries, are currently engaged in implementation of the Task Force recommendations. The NASD and the SEC receive periodic reports from these Working Groups and are monitoring progress as implementation moves forward.

As for the transactions that should have received discounts, NASD supplemented its referenced examination effort with a survey of every NASD member to learn more about each member's overall mutual fund activities. The survey, in turn, provided NASD with information that helped us frame a self-assessment. Specifically, NASD directed firms to perform an assessment of their own of breakpoint discounts delivery. These self-assessments were carried out through use of a carefully constructed sample of transactions, which permitted NASD to extrapolate each firm's performance to its entire universe of transactions. NASD has concluded that, during the 2001 to 2002 period covered by the self-assessments, investors were overcharged in about one out of every five transactions in which they were eligible for breakpoint discounts. Those overcharges, in our view, total at least $86 million, and the average overcharge was $243. When the assessments were complete, firms were directed to refund overcharges to investors, with interest. In addition, NASD will require that most of the firms involved undertake further action, including contacting their

customers individually to alert them to possible overcharges. Disciplinary or enforcement proceedings will be brought against certain of the firms.

Late Trading and Market Timing

Investment Company Act Rule 22(c)(1) generally requires that mutual fund shares be sold and redeemed at a price based on the net asset value (NAV) of the fund computed after the receipt of the order. In practice this requirement means that mutual fund shares are priced according to the value of their securities portfolio, computed at the next close of the national securities exchanges. For example, if a mutual fund receives an order to purchase shares before the close of the securities exchanges, 4 p.m., EST, the investor should receive a price based on that 4 p.m. close. If, however, a mutual fund receives an order to purchase shares after the 4 p.m. close, the investor should receive a price based on *the next day's* 4 p.m. close. This "forward pricing" requirement represents a fundamental principle of the Investment Company Act, for it prevents investors who might have access to the NAV of the portfolio from trading on that information.

The failure to meet the forward pricing standard has become known as "late trading." Late trading, however, should be distinguished from the practice, followed by many broker-dealers and other intermediaries, of transmitting orders after 4 p.m. because they require additional processing time. For example, some intermediaries may net out transactions by pension plan participants in order to simplify their order to the mutual fund company. In these instances, the participants entered their orders before 4 p.m., but the orders of the plan were not processed and transmitted until after 4 p.m.

The frequent trading of mutual fund shares in order to take advantage of pricing inefficiencies or market movements has become known as "market timing." Market timing is not per se illegal. Market timing activities become illegal when they violate the fiduciary duty of the fund's investment adviser; they also are problematic when they violate a stated policy of the fund as disclosed in the fund's prospectus. Many mutual funds police market timing by their shareholders, because market timing can increase fund expenses and can harm fund performance for the other shareholders. When a mutual fund has disclosed a policy of protecting investors from market timers, a broker-dealer may not knowingly or recklessly collude with the fund in order to effect a market timing transaction. Broker-dealers must have in place policies and procedures reasonably designed to detect and to prevent this collusion.

In response to prevailing issues concerning mutual fund execution, in September NASD sought information from roughly 160 firms regarding late trading and impermissible market timing.

As a preliminary matter, we have determined that numerous firms' conduct warranted a referral to NASD's Enforcement Department for further investigation and possible disciplinary action. Another group of firms is being examined by our Member Regulation Department for potential late trading and impermissible market timing misconduct. Specifically, a number of firms disclosed that they had, or probably had, received and entered mutual fund orders after U.S. markets closed for the day. Some of these firms disclosed specifically that they had accepted and entered late trades; other firms disclosed that they "probably" accepted and entered late trades. This imprecision in the latter group indicates separate issues of poor internal controls and record keeping. These matters, too, have been referred to NASD's Enforcement Department for action.

NASD also has identified a number of firms that were involved in market timing and it remains to be determined whether their activities were impermissible under our rules or applicable statutes. These firms appear to have facilitated a customer's market timing strategy in mutual funds or variable annuities, had employees who agreed with a mutual fund or variable annuity to market time the issuer's shares, or had an affiliate involved in some form of market timing of mutual funds or variable annuities. We are investigating any broker-dealer that made any of these disclosures in our investigations. We will investigate whether these firms simply allowed market timing, which is not per se illegal, or whether they colluded with the mutual fund companies to evade the fund's stated policies against market timing.

Investor Education

Mutual funds have been a particular focus of NASD's investor education efforts. This year alone, we have issued Investor Alerts on:

- Mutual fund share classes
- Mutual fund breakpoints
- Principal-protected funds
- Class B mutual fund shares

Each of these Investor Alerts educates investors about the wide variety of mutual fund fee structures that exist and urges investors to scrutinize mutual fund sales charges, fees, and expenses.

Research has shown that many investors are unaware of how much they pay to own mutual funds and that even small differences in fees can result in thousands of dollars of costs over time that could have been avoided. To help investors make better decisions when purchasing mutual funds, we have unveiled an innovative "Mutual Fund Expense Analyzer" on our website. Unlike other such tools, the Expense Analyzer allows investors to compare the expenses of two funds or classes of funds at one time, tells the investor how the fees of a particular fund compare to industry averages, and highlights when investors should look for breakpoint discounts. To make this tool more widely available to investors, we are developing a version of the Expense Analyzer for broker-dealer websites.

Conclusion

NASD will continue its vigorous examination and enforcement focus on the suitability of the mutual fund share classes that brokers are selling, the compensation practices between the funds and brokers, and the question of whether brokers are delivering to their customers the benefits offered to them, such as breakpoint discounts. And as we continue our examinations and investigations into late trading and market timing issues, we will enforce NASD rules with a full range of disciplinary options—which include stiff fines, restitution to customers, and the potential for suspension or expulsion from the industry. While NASD cannot alone solve all the problems revealed in recent months in the mutual fund industry, we have jurisdiction over all broker-dealers that sell these products to investors and will rigorously exercise our authority to take actions against violators as part of our overall efforts to protect investors and to restore investor confidence.

November 18, 2003

The Honorable Richard C. Shelby
Chairman
Committee on Banking, Housing, and Urban Affairs
United States Senate
Washington, DC 20510

Dear Chairman Shelby:

Much recent public attention has been focused on mutual funds, and rightly so. Whether we consider their role in providing financial resources to fund business growth and development and job creation, or we consider their significant service in helping people invest for education, retirement, or other needs, mutual funds are financial intermediaries that occupy a major place in our national economy.

In view of their importance, we applaud efforts to strengthen and protect the trust in the integrity of mutual funds and to bring to justice those who have violated that trust. Such misdeeds harm investors while threatening the ability of mutual funds to fulfill their valuable economic mission.

As Congress considers this matter, we would urge you to keep a few key principles in mind:

- Criminals who use mutual funds to steal from investors or otherwise engage in fraud and misdeeds must be apprehended and punished promptly in order to preserve the integrity of these financial institutions and to preserve the trust placed in them.
- We should make sure that fees associated with mutual funds are fully subject to the competitive tests of the market place.
- Information and disclosure requirements should be designed to provide investors with real value rather than serve mainly to increase costs and decrease returns.

We appreciate your leadership and commitment to a strong and vibrant financial system that employs capital, through the intermediation of mutual funds and other financial institutions, efficiently and productively to promote economic growth and higher standards of living. We look forward to continuing to work with you in that effort.

Sincerely,

John W. Snow
Secretary of the Treasury

Alan Greenspan
Chairman
Board of Governors of the
Federal Reserve System

UNDERSTANDING THE FUND INDUSTRY FROM THE INVESTOR'S PERSPECTIVE

WEDNESDAY, FEBRUARY 25, 2004

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10:03 a.m. in room SD–538 of the Dirksen Senate Office Building, Senator Richard C. Shelby (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN RICHARD SHELBY

Chairman SHELBY. The hearing will come to order.

Today, the Banking Committee continues its examination of the mutual fund industry. In November, this Committee held the first two hearings in a series to consider the ongoing investigations, enforcement proceedings, and regulatory actions concerning the mutual fund industry. Over the coming months, we will hold additional hearings as we examine the industry and consider whether legislative reform is needed. Although I have not yet determined the number of hearings, I expect the process to be comprehensive, deliberative, and informative.

A number of my Senate colleagues and fellow Committee Members have introduced legislative reform packages. Although these proposals contain various reform measures, I expect a fully developed hearing record to guide the Committee's consideration of any potential legislation. With well over 95 million investors and nearly $7 trillion in assets with that, mutual funds are the primary investment option for retail investors. Mutual funds have always been perceived as the safe, long-term investment option, but there is no doubt that recent revelations about self-dealing and preferential treatment have cast a shadow on the industry. Ordinary investors were shocked to learn the extent to which fund insiders, brokers, and privileged clients profit at the expense of the average investors.

The ongoing enforcement actions concerning late trading, market timing, and selective portfolio disclosure suggest that too often funds and brokers disregarded their duties to protect investor assets and act in the investors' best interest. Many of these practices were open secrets on Wall Street, yet they continued unabated and undetected by the SEC. Frankly, the prevalence of these problems must necessarily raise questions about the SEC's compliance and examination programs.

In addition to blatant malfeasance and compliance failures, this Committee will examine the transparency of mutual fund operations and the adequacy of current disclosure practices.

Many of the questionable fund practices are not disclosed to most investors. Furthermore, we have already learned about instances in which firms act in direct violation of their stated disclosures.

Therefore, this Committee, the Banking Committee, must take a comprehensive look at the industry to determine if the industry's practices are consistent with investors' interests. We may have to reemphasize the duty owed to investors to ensure that mutual funds are operating as efficiently and fairly as investors demand. In this regard, we will examine revenue sharing, directed brokerage and soft-dollar arrangements to determine how these practices have evolved and are currently used in the industry.

We will also review a range of disclosure practices regarding fees and costs, portfolio holdings, the portfolio manager's compensation and fund holdings, and side-by-side management of mutual funds and hedge funds. We will also focus on fund sales practices to ensure that brokers provide adequate disclosure of any sales incentives and information about different classes of fund shares and give clients any breakpoint discounts to which they are entitled. Although it is critical that investors receive clear, concise, and complete disclosure regarding their investments, we must be mindful of the possibility that information overload could overwhelm the investor and impede decisionmaking. Although better transparency and disclosure practices are key components of reform, true reform will require changes in the boardroom. Fund shareholders rely on the board to aggressively police potential conflicts of interest and to vigorously protect shareholder interests.

To some, the recent scandals suggest that many boards have abdicated their responsibilities. Whether boards were unaware of recent wrongdoings or turned a blind eye to such activities, I believe that either scenario calls for a serious review of board composition, decisionmaking, and responsibilities. I believe we must understand how changes to fund governance can minimize conflicts of interest and reinvigorate the boardroom culture to better protect shareholder interests. In our own ways, the regulators, industry participants, and Congress must collectively work to reform the mutual fund industry in order to restore investor confidence and integrity in the fund industry. State and Federal regulators must continue to vigorously prosecute wrongdoers in order to assure investors that fund executives and brokers who violate their duties and profit at the average investor's expense will be punished. Through enforcement actions, the regulators also help to define the full scope of transgressions, conflicts, and structural problems that are at the root of the misconduct in the fund industry.

While this Committee examines the fund industry, the SEC is pursuing an aggressive rulemaking agenda aimed at improving the transparency of fund operations, strengthening fund governance, and halting abusive trading practices. Chairman Donaldson told this Committee that the SEC has the necessary statutory authority to reform the mutual fund industry, and he is executing his agenda for reform. Understanding the scope, application, and consequences of the SEC's rulemakings will be an important element of this

Committee's process. Beyond rule proposals, the SEC must also demonstrate how it is revising its compliance and examination programs to ensure that brokers and funds comply with current law and to detect and halt future fund abuses.

The fund industry and brokerage houses also have a vital role in this reform process. It would be impractical, I believe, to expect the regulators to detect every single fraud and manipulation in the industry. Therefore, fund executives and brokers must rededicate themselves to the fundamental principles of our securities markets—the principle that securities firms and mutual funds should not neglect investors' interests and knowingly profit at their expense. Until firms can reassert the ideal of investor protection and demonstrate an ability to abide by it, investors will not trust the industry, nor should they.

Finally, Congress also has a critical role in the reform process. As this Committee examines the issues in the regulatory landscape, we must decide whether legislation is necessary. As we have learned in other contexts, however, additional legislation is not the only answer. While we consider various reform measures, we must be mindful of the cost of reform to investors and be wary of damaging the primary investment option for most Americans. We have an obligation to ensure that through either enforcement actions, regulation or legislation abuses are addressed and that transparency and fund governance improves. At the same time, we must ensure that funds and their fee structures remain subject to competitive market pressures and that reform measures truly benefit investors without having the primary effect of increasing costs and decreasing returns. The guiding principle of the overall reform process is investor protection—reassuring investors that mutual funds are a vehicle in which they can safely invest their money and not have their return on investment take a back seat to Wall Street insiders.

Building on this principle of investor protection, I hope that this reform process will give investors a better understanding of how the fund industry operates. Investing in mutual funds or any other investment vehicle is not a simple task as decisions require an understanding of risk and reward, and an awareness of potential conflicts of interest. To the extent that investors are more aware of their investment options and their inherent risks, our markets are better served. An educated investor is a better investor.

Our panelists this morning will share their insights on the fund industry from an investor's perspective and will also discuss ways to improve investor education.

With us this morning are Tim Berry, State Treasurer of Indiana and President of the National Association of State Treasurers; Jim Riepe, Vice Chairman of T. Rowe Price; Don Phillips, Managing Director of Morningstar Research; Gary Gensler, former Under Secretary of the Treasury for Domestic Finance, that we all know; and Jim Glassman, columnist for *The Washington Post* and Resident Scholar at the American Enterprise Institute. We look forward to your testimony.

Senator Sarbanes.

STATEMENT OF SENATOR PAUL S. SARBANES

Senator SARBANES. Thank you very much, Mr. Chairman. I join with you in welcoming this very distinguished panel this morning.

Again, I want to express my appreciation to you for the comprehensive approach you are taking to review the many issues surrounding the mutual fund industry.

Last year, the Committee held two hearings on this subject and heard from, among others: SEC Chairman Donaldson, SEC Enforcement Director Cutler, New York State Attorney General Spitzer, NASD Chairman Glauber, as well as the Investment Company Institute President Matthew Fink, and Securities Industry President Lackritz.

This is one of a series of hearings, and a number of additional hearings, as I understand it, have been scheduled on this important subject, which clearly merits the close attention that you are giving to it. As you mentioned, mutual funds are more than $7 trillion in assets and over 90 million Americans, half of all U.S. households, own mutual funds.

We were proceeding along without any sense of trouble. But then we had September 2003 when New York Attorney General Spitzer announced that a hedge fund, Canary Partners, had engaged in improper late trading and market timing. He predicted, at the time, that more instances of mutual fund abuse would follow. Regrettably, they have, involving additional cases of market timing and late trading, as well as misconduct involving revenue sharing, selective portfolio disclosure, failure to deliver breakpoint discounts, and other practices.

I think it is fair to say when we began our hearings last November, few of us anticipated the full dimensions of the problem. Since those hearings, almost every week, additional abuses have been revealed in many mutual fund families and securities broker-dealers, revealed by the SEC and by various State Attorneys General.

For example, just last month, in January, the SEC's Director of Enforcement announced that the SEC had found fund abuses involving revenue sharing at 13 unnamed Wall Street brokerages. On February 12, just a few days ago, the SEC and the NASD announced actions against 15 firms for failure to deliver mutual fund breakpoint discounts.

The proliferation of problems reflects, as the SEC said in a recent statement, "a serious breakdown in management controls in more than just a few mutual fund complexes."

In response, the SEC is actively engaging in rulemaking, and I want to commend the SEC for the focus they have brought to this issue and the speed to which they are moving in trying to address it. The problem has also prompted a number of our colleagues in Congress to introduce legislation on this subject. We have a range of statutory proposals that have been placed before Congress.

Questions have been raised about a wide range of issues: Sales practices, disclosure; how clearly and completely the types and amounts of fees and other important data are disclosed to investors; incentives that funds pay brokers to sell their shares; soft dollars; fund governance and structure; the performance of directors and their fiduciary duty to fund investors; the issues of firms that

run hedge funds and mutual funds together; and the effectiveness of regulatory enforcement.

I appreciate the quality of the panel that is here before us this morning. We are very pleased to have Tim Berry, the Treasurer of the State of Indiana representing the State Treasurers; Jim Riepe, Vice Chairman of the Board of Directors of T. Rowe Price Group, I think fair to say a venerable mutual fund institution, or at least we so think in Maryland; Don Phillips, Managing Director of Morningstar; Gary Gensler, who served with great distinction in the previous Administration as Treasury Under Secretary for Domestic Finance and is the co-author, along with Gregory Baer, of a popular book on mutual funds, "The Great Mutual Fund Trap," which makes for very interesting reading. You do not mind my giving a plug to your book here at the outset of the hearing.

Senator CARPER. What was the name of that book?

[Laughter.]

Senator SARBANES. And James Glassman, Resident Fellow at the American Enterprise Institute. I look forward to hearing the panel.

Thank you, Mr. Chairman.

Chairman SHELBY. Senator Crapo.

COMMENTS OF SENATOR MIKE CRAPO

Senator CRAPO. Thank you very much, Mr. Chairman, and I will be brief because the two of you have both very adequately stated my concerns as well.

I truly believe that without public trust and confidence, our markets cannot function efficiently and effectively. Recent revelations of wrongdoing, including the late trading and market timing contrary to fund prospectuses have undermined investor confidence.

I support the approach that you have taken, Mr. Chairman, and that is to make it very clear that investor protection is the principle which we must utilize as we proceed here to make certain that the duty owed to the investors by the mutual funds, and frankly, by the system that we establish is solid, and that it is understood well and that it is followed, and that the concerns that have arisen about whether the mutual funds are being managed in such a way that they are following the law and are being implemented according to the contracts and the principles that we expect of them is occurring.

At the same time, I appreciate the Chairman's comments that we also must look at whether new legislation is the best solution. The first principle we must follow, in my opinion, is to do no harm, and although there are certain serious problems that have been identified, I think it is also important for us to focus in this Committee, in our oversight role, on what the proper solutions should be. It is very possible that if we are not careful, we or others who are trying to address the issue, could actually raise costs and limit choices for investors which would be contrary to the very interests of those to whom this Committee and the entire mutual fund industry owe their highest duty, the investors.

So, I will be looking here at this hearing and throughout the hearings that we hold to be sure that we identify exactly what the problem is, and to identify what the solution should be, to make

certain that we achieve that ultimate goal of absolutely rock solid investor protection.

Thank you.

Chairman SHELBY. Senator Carper.

COMMENTS OF SENATOR THOMAS R. CARPER

Senator CARPER. Thanks, Mr. Chairman.

To each of our witnesses this morning, welcome. Some of you have been before us before, and for those of you who have been before, welcome back. To our State Treasurer, I used to be a State Treasurer, and our own State Treasurer is now a fellow named Jack Markell, who is a very able guy, and who I think you actually may reference in your testimony. I always say to Jack that he is the best State Treasurer we have ever had in Delaware, and he and others are quick to agree.

Mr. Gensler, we appreciate especially your service to our country and welcome you here today.

I do not come into these hearing with any preconceived notion as to what course we need to follow. I come into it with an open mind, not an empty mind, but an open mind, and I look forward to this team here helping to fill the mind a little bit. I think this maybe is the "A Team." Mr. Chairman, this is a good group and we look forward to their testimony.

Thank you.

Chairman SHELBY. Senator Hagel.

COMMENTS OF SENATOR CHUCK HAGEL

Senator HAGEL. Mr. Chairman, thank you. I would just add that I appreciate the distinguished witnesses appearing here this morning and that I look forward to their testimony.

Thank you.

Chairman SHELBY. Senator Sununu.

COMMENTS OF SENATOR JOHN E. SUNUNU

Senator SUNUNU. Thank you, Mr. Chairman. And like Senator Carper, I do not have any preconceived notion of what we ought to do here other than be cautious. As Senator Crapo said, we want to make sure that any solutions that we are contemplating are grounded in good empirical evidence that will actually address the very problems that we say that we are concerned about.

We should not be contemplating proposals that micromanage what is for the most part a very healthy and very vibrant industry simply because they sound good, simply because they have a nice rhetorical value or they make us feel like we passed legislation that dealt with the problem, because that ultimately can be counterproductive. I have emphasized this before in earlier hearings in this and other Committees, with regard to board structure, independent board members, independent board chairmen, if we pass legislation mandating the structure of the board, mandating a particular role and responsibility for an individual on the board, and then we say that that is dealing with this problem. There is no empirical evidence that boards of a particular composition are more or less prone to the kind of scandals we have heard about, then we are acting in a counterproductive way because we are creating in

the public's mind the sense that we have dealt with a problem when we really have not, and in the long run that will only undermine public confidence and credibility of the marketplace.

I think it is important that any proposals, ideas that we debate, discuss, and vet have some grounding in empirical evidence that they result in better governance, better management, and a better product for consumers in the long run.

With that, I look forward to the testimony of our witnesses today.

Thank you, Mr. Chairman.

Chairman SHELBY. All of the witnesses' written testimony will be made part of the Banking Committee's record without objection.

We welcome, all of you, to the Committee again.

Mr. Berry, we will start with you.

STATEMENT OF TIM BERRY INDIANA STATE TREASURER AND PRESIDENT, NATIONAL ASSOCIATION OF STATE TREASURERS

Mr. BERRY. Thank you, Mr. Chairman and Members of the Committee. Thank you for the opportunity to testify before you here today. As you said, I am Tim Berry, Treasurer of the State of Indiana, but also this year I am honored to serve as President of the National Association of State Treasurers, and it is in that role as well that I am here today.

As State treasurers we directly oversee more than $1.5 trillion in State funds. Additionally, many of us directly oversee or sit on boards that oversee our public pension funds, our State 401(k) and deferred compensation plans, and most importantly and significantly, State treasurers for the most part have direct oversight of the Section 529 College Savings Plans in our States, where citizens, families have invested more than $50 billion over the last few years in those plans.

What is at stake here? Investor confidence, investor trust. It is imperative that all of us, large institutional investors as we are as State treasurers, regulators, as well as the mutual fund industry itself, place a priority upon the investor interests. Unfortunately, though, allegations, as you have discussed already, of wrongdoing go beyond just a "few bad apples," but it appears to involve a significant number of mutual fund complexes. The National Association of State Treasurers and many of my State treasurer colleagues on their own have been on the forefront of calling for investor protection reforms. Much of the focus over the last year of the NAST activities, through the creation of a Special Corporate Governance Committee and through our own association work, has dealt with the issues that we are discussing here today.

In recent months the Securities and Exchange Commission has taken a number of steps to address the issues that have been raised by State and Federal investigations into the mutual funds' sales and trading practices. There are several principles in which the treasurers and the Commission agree will bring about investor confidence and trust. I will address two of those here today in transparency of fees, and also fund board independence.

Mutual fund shareholders, in order to better understand and gain comfort of their investments, should receive a statement of

charges debited from their account for management, 12b–1 and other expenses. It is important that this billing information be both consistent and thorough and until this system of consistency has been developed, it is necessary that greater and clearer disclosure take place immediately. It is also recommended that only the independent directors may vote to approve board fees. They will base this decision on an itemization of expenditures associated with investment advisory services, marketing and advertising, operations and administration, and general overview.

Also as it relates to the board structure, many of us believe that 75 percent of the mutual fund's board of directors shall be independent directors, along with an independent chair. This is a necessary component of providing increased investor confidence and trust. We also believe that it is important that these independent directors meet at least annually with their chief compliance officer and with the independent auditors without the presence of management to deal with the many issues that are at stake here. These are two of the important components of the mutual fund protection principles.

We commend the Commission for their efforts and believe their actions will go a long way toward rectifying many of the abuses identified in recent allegations of the mutual fund industry. But in order to succeed in our dynamic American economy, we must ensure that through these reforms, transparency, and greater understanding by the individual investor, will be achieved through greater financial literacy. Our citizens must be equipped with the skills, knowledge, and experience necessary to manage their personal finances, their college savings, and their personal retirement needs.

State treasurers have long been involved and recognize the importance of financial education. Through legislative process, State treasurers support public policy positions that promote savings and are actively educating our citizens on savings from birth to retirement. These financial literacy programs range across the board to a variety of target demographic groups, from school-age children, to women, to senior citizens, to our local public finance officers. Through these personal finance workshops citizens are learning how to take control of their own financial situations. Over a third of our State treasurers have implemented women and money conferences and continuing education seminars. Delaware State Treasurer Jack Markell has developed an innovative Delaware Money School, designed to bring community-based financial education to participants in a pressure free, no-selling environment.

A few of the States, as we do in the State of Indiana, provide educational programs for our local public finance officials. These workshops provide participants, our county treasurers, city clerk treasurers, town officials, the school business officials, and tools to deal with the fiscal and ethical issues that they face when investing public resources.

By bringing about more visibility to the corporate structure of funds and by enhancing the availability of usefulness of financial information disclosed by these firms, this Committee can demonstrate to the American investor that mutual funds will continue

to operate as the cleanest, brightest investment method for all Americans.

Chairman SHELBY. Thank you so much.

Mr. Riepe.

STATEMENT OF JAMES S. RIEPE
VICE CHAIRMAN, T. ROWE PRICE GROUP, INC.

Mr. RIEPE. Thank you very much, Chairman Shelby, Ranking Member Sarbanes, and all the Members of the Committee. I am James Riepe, Vice Chairman of the T. Rowe Price Group, CEO of the Price Funds and Chairperson of all of those Price Fund Boards.

T. Rowe Price is a Baltimore-based investment management organization, close to $190 billion in assets under management, about $120 billion of that is in mutual funds, and we have been managing investments for nearly 70 years now, and I personally have been in the business for about 35 years.

I very much appreciate the opportunity to talk to you about my firm's efforts to respond to the challenges facing us today, investor reactions to these challenges, and to share my views on regulatory changes that I think will help funds move investors forward.

Let me begin by saying that at T. Rowe Price we have always lived by the principle that the interests of our fund shareholders are paramount. As such, we have been deeply dismayed by certain abuse of mutual fund trading practices revealed during the last 6 months. On the heels of the corporate and Wall Street scandals and because mutual funds historically have been largely untainted by abuses in the conduct of their business, these revelations have attracted extensive attention from the regulators, the press, and the legislators.

Although painful to those of us who are immersed in the task of stewarding investor assets, I believe this additional attention and scrutiny, excluding the hyperbole that has accompanied it, is healthy and will benefit most fund investors and those of us who serve them. I think your hearings, Mr. Chairman, should further enlighten that process.

My firm, and I might add, my colleagues in this industry as well, support appropriate and decisive action by Government authorities to redress these abuses. We also support changes to bolster an already strong regulatory system. In my view, the SEC has responded to the recent abuses swiftly and with the most comprehensive mutual fund regulatory reform agenda in recent history, certainly in my history. I have stated many times that one of the key factors in the success of mutual funds is the regulatory scheme under which funds have operated for all these years.

A little more than 11 years ago I sat in front of your Securities Subcommittee and argued that SEC's resources had not kept up with industry growth. I repeat again today that continued effective oversight by the SEC, as well as the successful implementation of any new reforms, cannot be achieved unless the SEC is adequately and consistently funded.

Mr. Chairman, as your Committee reviews the current mutual fund situation and regulatory responses, we all need to understand that in the end ethical behavior cannot be regulated, no matter how extensive the compliance regulations. Ultimately, each one of

us must create an environment within our organizations in which the right decisions are made by our employees consistent with our obligation to investors. Although we have seen very strong evidence that investors continue to recognize the fundamental benefits of investing in mutual funds, we also have witnessed several harsh examples of what can happen if damage is done to the implied bond of trust between investors and fund managers.

Notwithstanding the improvements represented in some of the proposed reforms, we recognize that the challenge of maintaining investor trust falls primarily on those in the fund industry and its intermediaries and not on the Government. At T. Rowe Price, we take this responsibility very, very seriously. We have in place, for example, procedures and practices that seek to protect our fund shareholders against late trading, abusive short-term trade in the mutual fund shares, and the selective disclosure of fund portfolio holdings.

In light of the recent investigations and enforcement proceedings, we have conducted thorough reviews of all of these areas. We have confirmed that our policies and practices consider to be effective. We considered ways we might make them even stronger. As an example, we are expanding our annual compliance review meetings to include all of our employees instead of just our senior staff.

During this review process, we have, as always, kept the fund boards fully informed, and they have played an active oversight role, including their decision to extend redemption fees to a number of additional funds.

With respect to investor communications, we have sought to educate fund investors about these particular issues. We have used letters, newsletters, and our website to discuss the fund trading improprieties and how we seek to protect Price Fund shareholders from such abuses.

Our internal efforts have been supplemented by a series of very substantive SEC regulatory initiatives. Today, I even understand that the SEC may be proposing a new rule that would impose mandatory redemption fees on transactions and certain types of fund shares where shares are held for 5 days or less. We strongly support most of these SEC initiatives and anticipated actions which are discussed in much more detail in my written testimony. And I believe that they will go a long way toward stamping out abuses and maintaining the confidence of investors which you all have talked about.

I would also like to say a few words about fund governance. In my opinion, the recent disturbing revelations about mutual fund abuses do not evidence a failure of the fund governance system, as some industry critics have charged. These were failures of management, not fund governance. Fund directors cannot and should not be expected to oversee day-to-day management of the fund's activities. However, these failures have served to highlight that fund directors could benefit from being given additional tools to assist them in executing their oversight role more effectively. Most important of these new tools was a rule already adopted by the SEC in December that requires mutual funds to establish comprehensive compliance programs and to appoint a chief compliance officer who will report regularly and directly to the independent directors on

all compliance matters. We strongly believe that this rule, probably more than any of the other proposed reforms, will have the most far-reaching effect on how fund managers conduct their day-to-day business, and it should significantly improve the directors' ability to oversee fund compliance.

The Commission also has proposed certain new governance requirements, such as requiring that a fund's independent directors periodically meet in executive sessions, that fund boards conduct regular self-assessments, that the independent directors have the express authorization to retain experts and hire staff. Although ours and many other fund boards already adhere to these practices, formal requirements will emphasize their importance.

Unfortunately, a few of the SEC governance proposals are, in my view, unwarranted, unrelated to the abuses that have been discovered, and in fact, could be counterproductive, as Senator Sununu pointed out. In particular, the idea of a Government mandate that all fund boards must have an independent chair makes no sense to me at all. Recent events demonstrate that having an independent chair is certainly no silver bullet. Since independent directors constitute at least a majority and typically a supermajority of fund boards, why should those directors not be allowed to determine who their chair should be? In the case of T. Rowe Price, we have had at least a two-thirds supermajority of independent directors for many years, and they have appointed a lead director. They do not believe they need an independent chair to enhance their influence, but would name if they wanted to. For example, they have retained their own independent fund counsel for more than two decades, and several years ago they requested that the fund's advisor change its independent auditing firm because it was also the fund's auditor. Although changing auditors in a public company is a very big deal, as you all know, we made the change.

Let me quickly mention two other SEC initiatives with respect to fund distribution. We support the SEC's recent proposal to ban the practice of directing fund brokerage transactions to reward broker-dealers who also sell fund shares. Further, we believe the Commission's decision to take a fresh look at Rule 12b–1 is both prudent and timely. The SEC has also proposed to require broker-dealers to give mutual fund investors a new point of sale disclosure document containing information about sales related fees and payments. This is consistent with a longstanding fund industry recommendation, I might add. If executed properly, and perhaps not limited to just sales related costs, I believe that this document could meaningfully enhance the investor awareness and understanding of a fund's investment program, its risks, costs, and fees associated with it.

In closing, I would like to emphasize that T. Rowe Price has been and continues to be committed to acting in our fund shareholders' interest, and we believe most other fund managers seek to do the same. We understand very well the fiduciary relationship that exists between us and our investors. We also know that we operate in a highly competitive marketplace and we understand that over time, in order for us to be successful, our investors much be successful. The current challenges have presented those of us in the fund industry with an opportunity not only to improve the regu-

latory scheme under which we operate, but also to recommit ourselves to investor interests. I assure you, we will all take advantage of that opportunity.

Thank you.

Senator SARBANES [presiding]. Thank you very much. I might note to my colleagues that there is a vote going on. The second bells have rung. Chairman Shelby went at the outset. He hopes to get back before we all have to depart to vote, in which case the hearing can continue. If not, I will recess at the appropriate time and we will flee the room in order to make the vote.

Mr. Phillips, we would be happy to hear from you. Let me just note, though, that we very much appreciate the careful thought and effort that obviously went into the written statements. We have had a chance to review them, at least preliminarily, and I must say I am struck by the care and the comprehensiveness of many of the statements. It is enormously helpful to the Committee that this effort has been undertaken by the people who are on the panel today.

Mr. Phillips.

STATEMENT OF DON PHILLIPS MANAGING DIRECTOR, MORNINGSTAR, INC.

Mr. PHILLIPS. Thank you for the opportunity to appear before this distinguished Committee. My name is Don Phillips and I am a Managing Director of Morningstar.

As a leading provider of mutual fund information to both individual investors and their financial advisors, Morningstar has had a front-row seat to witness both the rapid rise and the recent missteps of this important industry. We have seen a generation of Americans embrace mutual funds for their compelling combination of convenience, instant diversification, and professional management. The industry's rise has not solely been due to these merits, however. The mutual fund industry has also been the beneficiary of considerable good fortune. Numerous legislative acts such as those allowing individual retirement accounts, 401(k) plans, and 529 plans have encouraged investors to place billions of dollars into funds, greatly enriching those companies that offer them. As a result, mutual funds now occupy a central position in the long-term savings plans of more than 90 million Americans.

Given the privileged and highly important role that mutual funds now play, it would behoove the industry to redouble its commitment to the effective stewardship of the public's assets. Most individuals who work for mutual fund companies embrace this challenge, but the recent scandals make it abundantly clear that too many people in this industry were willing to forsake their responsibility in exchange for short-term personal profit. Investors are angered and confused by these scandals. While few question the inherent benefits of mutual funds, it is clear that the industry has foolishly jeopardized its greatest asset, the public's trust.

Investors need reassurances that their trust will not be further betrayed. In particular, I believe they need to know that mutual funds operate on a fair and level playing field, that checks and balances exist to safeguard investor interest, that adequate information will be available to allow investors or their advisors to make

intelligent decisions about their funds, and ultimately that mutual funds offer a reasonable value proposition.

While market forces can and will do much of the work, the industry and regulators can take steps to ensure that mutual funds meet their obligations to the American public. Specifically, Morningstar endorses these 10 steps:

(1) Close the door to timing and late trading abuses so that short-term traders do not undermine the returns of long-term investors. (2) Eliminate directed brokerage and better disclose pay-to-play arrangements so investors know that the funds chosen for their portfolios are done so on the basis of investment merit, not on the willingness of the fund to pay for shelf space. (3) Eliminate soft-dollar payments so investors can see the full cost of investment management. (4) Eliminate or seriously reconsider the role of Rule 12b–1 fees, to make clear to the investor which costs go to pay for fund management and which costs go to pay for distribution. (5) Maintain vigilant and appropriately funded regulatory oversight. (6) Make fund directors more visible and more accountable to shareholders. While much has been made about the independence of directors, we think a much more important issue is the visibility. What is deeply alarming is in situations like Putnam, where there have been whistleblowers, the whistleblowers did not even think to go to the fund boards. If the fund boards are out of sight and out of mind, they cannot fulfill their responsibility to investors. (7) Disclose fund manager trading and their trades as a deterrent to the activities seen at Strong and Putnam where managers traded their funds aggressively while encouraging investors to hold on to theirs. (8) Disclose fund manager compensation. All investors have a right to see that their interests are aligned with management's. When it comes to equities and common stocks in the United States, investors have the ability to see how management is compensated and how they are incentivized. When it comes to mutual funds, investors do not have access to that same basic information. (9) Improve portfolio holdings disclosure so that investors can make better use of funds. Too often in the late 1990's we saw investors buying what they thought was a diversified fund, only to learn the hard way that those funds in practice had more than half of their assets in technology stocks. If investors do not know what is in their funds, they cannot use them wisely. (10) State fund costs in actual dollars like any other professional fee is stated, so that the market can work efficiently and there can be a true debate over whether it is good value brought for the cost that is charged.

Mutual funds have a proud history, but the recent scandals have badly damaged the industry's credibility. Collectively, legislators, regulators, and industry leaders can rebuild the public's trust in mutual funds. Investors need assurances that the field is level, that safeguards exist, that their manager's interests are aligned with theirs, and ultimately that mutual funds represent good value. By addressing these concerns the industry can get back on track to helping investors meet their goals and secure a safer future for their families.

Thank you very much.

Senator SARBANES. Thank you.

We are going to suspend the hearing, we need to go vote. As soon as the Chairman returns, the hearing will resume.

[Recess.]

Chairman SHELBY [presiding]. The hearing will return to order.

Mr. Gensler, we have a vote going on as you know. I tried to get here for Senator Sarbanes. We will all be coming and going.

Again, welcome to the Committee. You have spent a lot of time around us. Thank you.

STATEMENT OF GARY GENSLER
FORMER UNDER SECRETARY
FOR DOMESTIC FINANCE
U.S. DEPARTMENT OF THE TREASURY

Mr. GENSLER. Thank you very much Mr. Chairman and Members of the Committee.

Chairman SHELBY. Other Committee Members are on their way.

Mr. GENSLER. Mr. Chairman, I believe that the scandals reveal the need for substantive reform in mutual funds governance. Only when independent directors act in the full interest of investors will we safeguard against the inherent conflicts that will always be there. These conflicts will not go away, lest we forget. But fund management companies, as distinct from the funds themselves, have their own shareholders and their own profits to consider. That is natural. That is good. Many of them will charge high fees even if this lowers investors' returns.

The SEC has been very active addressing specifics of late trading, market timing, breakpoints, ethics officers, et cetera, compliance officers, and in many ways these are very good actions, but they in some ways treat the symptoms of a greater problem. To address that problem——

Chairman SHELBY. Explain. You are going to though, explain if treating the symptoms and not the real fundamentals.

Mr. GENSLER. I believe that the Congress will need, if they wish to address the core problems, to mandate that independent directors truly act as gatekeepers for the benefit of investors, not in name only, but in reality, and I believe that we simply have no choice but to do this as we prepare for the retirement of the baby-boom generation.

I see this whole debate about mutual funds around preparing ourselves for this inevitable retirement of the baby-boom generation, and Congress will address itself to Social Security, Medicare, and so many other things, but this is a core of that same debate.

Mutual funds operated in the best interest of investors would, in fact, lower costs and increase investor returns, and if that were the case, would increase retirement savings and ultimately lower the cost of capital for the overall economy. I think that is what is at the core of this debate.

The SEC noted, just for instance, that a 1 percent increase in the funds' annual expenses can reduce investors' account balance in the fund 18 percent after 20 years. It is just arithmetic, but it is a critical factor. With costs totaling close to 3 percent a year for the average investor, about half of that is the annual expense ratio, but then there is the portfolio trading costs, the triggering of short-

term capital gains, and of course, half of funds have sales loads on top. It is about $100 billion a year for the overall industry.

To accomplish these goals I believe that Congress should look at: First, strengthening fund governance; second, restricting payments under 12b–1 fees and soft dollars, and of course, third, enhancing certain disclosures.

While the SEC has an important role to play, I do not believe that they can do it all by themselves. In terms of governance in particular, I think the most important thing to do is to clarify the duties of independent directors and the standards to which they are held. In practice, fund directors have a difficult time striking a proper balance between working with the advisor and pursuing investors' interest. Why is that? First, directors are recruited by the fund companies and serve on a multitude of fund family boards. They serve only part time, of course. They rely solely, and if not solely, largely on management company for all of their information. In addition, there is a landmark case that has proved to be somewhat insurmountable. It is called the Gartenberg case. The Second Circuit's Court of Appeals in 1982 ruled what? That "To be found excessive, the trustee's fee must be so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining."

The result of that? Twenty years later not one shareholder has subsequently proved a violation of the Gartenberg standard and not once has the SEC sued a fund director for failing to review adequately the advisory agreement. I truly believe that there are many great firms in the mutual funds industry, but to think, with 9,000 funds and 20 years there have not been any bums that have failed to live up to a standard, tells us something about the standard.

So in this environment, how many well-meaning directors would really make waves? What if mutual funds directors were actually vigorously negotiating fees and other costs? Would not retirement savings increase in America? While I am not suggesting, as some have, that we have mandated requests for proposals and changing fund advisors, I do believe that the 1940 Act could be amended to include a general fiduciary duty for directors to act with loyalty and care in the best interest of shareholders. I believe it can mandate that the SEC promulgate rules for directors in carrying out these duties, requiring that independent directors formally meet without the interested parties, spell out the list, a small list of the major contracts that they have to really review and get their minds into. Maybe they should require true arm's-length negotiation. It is a tricky area. It is not without its pluses and minuses, and then, of course, I think amend or repeal the Gartenberg standard. The SEC cannot do that. Only the Congress can. It is another situation where the courts, albeit 20 years ago I think, took a step maybe too far.

I do believe that it is important that the definition to independence be tightened, and how we recruit and select directors, and I also do support the SEC's proposal on board chairs and 75 percent independent directors. I would say though it is not a silver bullet. Current law already requires that independent directors review and make the key decisions, but legislation really should clarify

how they make the decisions, and this earlier comment on the Gartenberg decision. But let me say anybody who doubts the importance of a chair, just think about all the energy, politics, and resources that goes to putting you, sir, in that chairmanship there. So, we all know there is some relevance to a chairmanship.

Beyond governance, I believe that Congress should give serious consideration to restriction of 12b–1 fees and soft-dollar agreements. Most importantly on 12b–1 fees, they were promulgated in another time, in another era, and I think their time has come. They have not served their useful purpose.

On greater disclosure, while there is a series of things in my written testimony, I think most relates to disclosing portfolio trading costs; eats up about a half a percent to three-quarters a percent a year. It can be estimated. It can be disclosed. I think it is very relevant.

In sum, again, I think this is all about retirement savings and promoting retirement savings, and within that window I think there is a call and a need for Congress to act beyond that which the SEC is doing.

Thank you very much.

Chairman SHELBY. Thank you.

Mr. Glassman.

STATEMENT OF JAMES K. GLASSMAN RESIDENT FELLOW, AMERICAN ENTERPRISE INSTITUTE

Mr. GLASSMAN. Thank you, Mr. Chairman, and thanks for inviting me today.

In the wake of the scandals involving late trading and market timing in mutual funds, a flood of proposals both legislative and regulatory have been introduced to change the industry. My message to you today is that you should proceed extremely cautiously in making changes. I say this as someone who has written a syndicated financial column for the past 10 years, as well as two books geared toward small investors. I fear that many of the proposals will hurt and not help small investors by adding costs and by reducing choices. I will review them briefly and recommend different approaches.

But first let me say something as clearly as I can, the American mutual funds has been the most successful financial vehicle of all time. In 1970, there were 361 funds. Today, there are 8,124. In 1970, assets totaled $48 billion; today, $7 trillion. The mutual funds is a very simple idea, a portfolio shared by thousands of shareholders, composed of stocks, bonds, or cash managed by a professional. In the past only the rich could afford this. Now about half of the households own mutual funds. They pay modest fees. For no-load equity funds, an average of about $125 a year for every $10,000 in assets, the most popular fund charges $18 a year, and investors have vast choices.

This is a highly competitive industry, and it is getting more so. The top five fund houses account for only one-third of assets, and studies show that fees are falling. And I urge you, do not do damage to this success. You do so at the peril of the U.S. economy and the well-being of small investors. I agree with what Senator Crapo said earlier, "first, do no harm."

Investors have already spoken in response to the scandals, and very forcefully. They have withdrawn money from the accused firms and they have rewarded untainted firms. Just as one example, $29 billion in assets was withdrawn in 2003 from Putnam, one of the miscreants, last year. Meanwhile, three untainted firms—American, Vanguard, and Fidelity—gained a total of $133 billion in assets.

Let me just move quickly to specific proposals. I oppose a hard 4 p.m. close on trading activity since it hurts small investors who will have to get their orders in many hours before the close or suffer stale pricing. I oppose a mandatory 2 percent redemption fee because it serves as a kind of price fixing cartel for mutual funds, and impedes the exit of dissatisfied investors. Instead, you should encourage the exit of investors as a way to discipline poor funds. In that regard, I back a proposal by Bruce R. Bent to allow unlimited rollovers from one fund to another without incurring capital gains taxes. Currently, taxes prevent exit, helping a poor fund keep customers.

I oppose proposals to increase independent directors and have an independent chairman. Academic research and common sense show that this is no solution to bad governance. Enron had 11 independent directors who headed every single one of its board committees. Instead, I suggest a reexamination of the antiquated legal structure of funds set by a law 64 years ago. This kind of reexamination has been advocated by Amy Borrus and by Paula Dwyer of *Business Week* and many others. Why should 8,000 funds each be a separate company with a separate board? Funds should be treated in the law as what they are and what people think they are, investment vehicles offered by investment firms.

The concern over the composition of fees is equally misguided. Investors do not care whether this or that charge is ascribed to 12b–1 or to management fees. Let every firm simply state charges without ascribing costs. When I buy a bicycle the company does not say that the price comprises this much in health care costs and this much in rubber.

On disclosure, let us be serious. My readers do not pay any attention or pay very little attention to current disclosures. Why add a dozen more? No industry discloses more about its fees and performance. I would very much like to see competitive disclosure, absolutely, where companies brag about their best points including their low fees, but let the companies make these decisions in response to what investors really want.

Now, my most important recommendation. Finance is rapidly becoming democratized in the United States, primarily by the mutual funds and the 401(k) plans. But too many Americans know too little about the basics of finance. Investor education is a job for Government, as well as the private sector. Current efforts are diffused and underfunded, and it is investor education, not more rules, that you should put your energy into.

Finally, I want to congratulate Eliot Spitzer, William Donaldson, other regulators, law enforcement authorities, and the Congress, who have moved quickly to uncover and prosecute the miscreants in the current scandals. Illegal and fraudulent activity was found and perpetrators were punished. This is hugely beneficial, but this

does not mean that major changes are necessary in the regulation of funds. I urge you to proceed with a yellow or even a red light, but not a green light.

Thank you, Mr. Chairman.

Chairman SHELBY. Thank you, Mr. Glassman. I thank all of you.

Mr. Riepe, some question the sincerity of recent efforts by funds to reach out to their investors. For many there seems to be a credibility gap between what the funds are doing now compared with what so many were doing before the recent revelations. How do you address this assertion and how can the investing public be sure that funds will continue on the straight and narrow once the current attention has shifted away?

Mr. RIEPE. Obviously, I cannot speak for the thousands of fund groups out there, Mr. Chairman, but I can tell you——

Chairman SHELBY. Speak for your own company.

Mr. RIEPE. As I said, in our particular case, we actually have had very few inquiries from investors about this. Just to take one, I had a review done of the hits to our website, and we have an icon up on our website that talks about the mutual funds abuses, and less than one-hundredth of 1 percent of the hits over the last 2 months went to that site.

Chairman SHELBY. Is that because they have confidence in T. Rowe Price?

Mr. RIEPE. We hope it is some of that, but obviously it is also in terms of what people's interests are, and what we have found is the people who are invested with someone whose name has been in the papers as being involved, has suffered a very big penalty and those people are very aware of it. The rest of the industry, which is the bulk, obviously, of the industry, that has not been tainted by that, those investors accept that. What that says to me is that the people are not worried about the underlying fund structure. They are not worried about mutual funds. It is not the S&L scandal where you worried about every S&L even though yours might not have been in the headlines. In this case it seems to me that investors are only worried about those that they have seen in the papers.

I do think we are trying to communicate, and I do not think people are being duplicitous in terms of how they communicate. As Mr. Glassman pointed out, the penalty that has been exacted on those whose names have been in the paper under these allegations has been much, much more severe——

Chairman SHELBY. Comes in the market, does it not, sometimes?

Mr. RIEPE. Yes. The market takes care of those things, and much more so, frankly, then the penalties that the prosecutors have had. So anybody who is not watching that, and is not changing their behavior if, in fact, it has to be changed, I think is making a very big mistake.

Chairman SHELBY. Mr. Phillips, many investors are understandably concerned about the fund industry and are trying to understand the full scope of recent problems. What factors should investors monitor over the next few months as they evaluate their portfolios, and how would you advise the investing public to respond to the wrongdoing in the industry? Are they already responding?

Mr. PHILLIPS. I think clearly they are responding, and I think they are responding in an intelligent fashion. We have seen money go into the fund industry at a near record rate, which says that investors recognize that there is something very right about this industry at its core, and I would point out that——

Chairman SHELBY. Are the investors being a little selective on what funds to go into?

Mr. PHILLIPS. Absolutely, they are being more selective. First, they realize that there is a good value here. We track funds in 17 different countries, and nowhere else in the world is the value proposition of mutual funds as strong as it is in the United States. So there is something about the system, whether it is the corporate structure, the directors, the entire way that the industry is policed that is working for investors, but investors have radically been moving their money away from those groups that have been named and toward the others.

But I would argue that what is really happening is an acceleration of a trend that was already in place. You see the major companies that are winning in this industry, firms like T. Rowe Price, firms like Fidelity, Vanguard, American Funds, these are firms that not only have not been involved in the scandals, but they are also firms that——

Chairman SHELBY. Integrity counts.

Mr. PHILLIPS. Integrity counts, and integrity shows itself in many ways. None of these firms offered Internet funds, whereas a lot of funds that were involved in the scandals were out offering the hot fund at the wrong time at the market peak. All of these funds have offered at below-market cost. Investors recognize integrity over time. The question is: Could you state costs more clearly so that investors do not have to suffer through 10 years of bad performance in a high-cost fund before they recognize the debilitating effect that high costs have on performance in the long-term.

Chairman SHELBY. I want to pose this next question to Mr. Glassman and Mr. Gensler. But I want to first tell Mr. Glassman, we are proceeding with caution because I think that if we are thorough in these hearings we learn more and we should not rush to judgment. This industry is too big. It is too complicated, it is too important to do otherwise, and we are pretty aware of that up here. I appreciate your remarks.

Mr. Glassman and Mr. Gensler, some contend that the presence of so many high-cost funds is proof that competitive market forces, which should theoretically drive down prices, are not working in the fund industry. How would you respond to this assertion, Mr. Glassman? Why is it that some funds can attract billions in assets with relative poor performance and high fees? Should regulators mandate fees? That would be troubling to me.

Mr. GLASSMAN. That would be extremely troubling. Investors want and need help, and they are willing to pay for it. So that it is not simply the returns that a fund produces that should be the factor on which people make decisions about which funds to buy. People need hand-holding. People need the kind of advice you get from a third party, and usually these commissions, loads are being paid to funds that result through third parties. But they have choices, and they have massive choices, and they can go to a fund

like Vanguard Index 500 for 18 basis points, and get what they want with less hand-holding but lower returns.

The second reason—and this I bring up in my testimony at the end—interesting new research, really is that investors are not as educated as they ought to be, especially investors who have entered the market recently. They really do need help. I just will give you an analogy. I mean if I were to go look for a tie at some mall in Washington, I would pretty much know where to find the best value at the lowest cost. But if you plunk me down in Morocco and tell me to find a tie, I would have a hard time doing it. Now, I might just go to a brand that I trust if I see a brand name somehow in the souk in Morocco that I trust, and that is the position that many investors are in, and we really need to help them.

Chairman SHELBY. Mr. Gensler.

Mr. GENSLER. I would say first, I do not think that Government, the SEC, the Congress should mandate fees.

Chairman SHELBY. Thank you.

Mr. GENSLER. I think that is just not my upbringing. I think markets do work well.

But I do think that this overall market breaks down in a number of ways, and let me name five of them very quickly, and I detailed this more in my written testimony. One is investors. We Americans have a collective desire to rely on experts and in particular in that reliance on experts to chase past performance. Why is it that every January and February we see the financial magazines showing the hot funds of last year. It is not the magazines' fault. It is because we Americans want to read about the hot funds of last year. Two, I think that there is an effective advertising of the mutual funds industry. That is good business to promote the hot funds of last year, but every academic study shows the hot funds usually are not that good performing next year. Three is the inherent conflicts of brokers and financial planners. All of these things, their revenue-sharing arrangements, they come back to haunt us when a broker is pushing a fund that is not necessarily the best fund. Yet, many funds feel they have to engage in it. T. Rowe Price, which I think is one of the finest firms—but I have to admit a conflict here, Jim. My identical twin brother works for Jim—but does not pay loads, but why do half the funds——

Chairman SHELBY. It does not help much.

Mr. GENSLER. You mean the twin brother? They do want to know why he cannot control his brother better.

Chairman SHELBY. That goes on in families.

Mr. GENSLER. That does go on in families.

My point of this though is that half of all funds feel they have to pay loads to get access to that distribution. That pushes up costs. Four, is the unique way the industry charges for the fees. We are not going to change this, but it is just a reality that it is very convenient. It is just taken out. You do not have to write a check for it, and I am not suggesting changing it, but it is a reality.

And last, there is a practical barrier to changing fund families. Many investors are invested through 401(k)'s, their corporation picks the fund, many investors find they want to keep a money market fund where they have other funds. So, they are just a prac-

tical reality. I think those five reasons make it more difficult for market forces to work as cleanly as we would like them to.

Chairman SHELBY. Senator Sununu.

Senator SUNUNU. Thank you, Mr. Chairman.

Mr. Gensler, in your testimony you state that there is no way a chair who also works for an investment advisor can satisfactorily serve two masters. What evidence is there to support that claim?

Mr. GENSLER. The evidence really is the history of high fees. As I said in the testimony as well, or in my oral statement, I believe that many of these scandals, the market timing, the late trading and so forth, will be addressed by the SEC and in many ways adequately addressed. But they are symptomatic of something other about governance, and it is a very difficult challenge that these fund directors, not one that I would wish to have for myself, being selected by the fund management company and then being put in a position to try to serve the best interest of investors.

Senator SUNUNU. Are you suggesting evidence that funds with chairs that work for investment advisors historically have demonstrated higher fees than those funds that do not?

Mr. GENSLER. I have not seen data on that, but to be able to serve as a chair and both promote the highest profits for a fund company while at the same time trying to promote the highest investor returns is a conflict of two sets of fiduciary duties. It is a burden that really cannot be managed I believe. How do you maximize the profits of the fund company and rightly maximize the profits of the fund company, and at the same time maximize the returns to the investors.

Senator SUNUNU. I mean it seems to me that history has shown that the way to maximize the returns of the fund is to ensure that investors have confidence in that fund and thereby are willing to invest money with that fund, and if recent history has shown us anything, it is that investor discipline against those funds that lose public confidence or credibility can be stunningly harsh. The folks at Putnam, I am sure, will attest to that.

Mr Riepe, could you talk a little bit about the concept of an independent lead director? What does that mean? What is their role, and how do they interact with an interested chairman in the case where there is one?

Mr. RIEPE. Yes, Senator. In fact, in response to your question to Mr. Gensler, I think there is a lot of data, and the fact is that all of the very low-cost funds out there also have chairmen who are members of the advisors and come from the advisor. So the evidence is quite strong that the chair has nothing to do with the fees. Otherwise, we would have no low-cost funds because most of the chairs are also involved with the advisor.

Senator SUNUNU. I am sorry. I just want to be clear. You are suggesting that interested chairs that may also serve the advisory company actually understand that low fees attract customers and enable them to make more money?

Mr. RIEPE. I am saying that we have, for example, in T. Rowe Price's case, we have an interested chair who is chair of the fund boards, and our mutual fund fees, 100 percent of our funds below the average of all of their groups, and there are other fund groups with fees lower than ours, and they also have interested chairs. So

the correlation between an interested chair and a disinterested chair seems to me to have very little to do with the cost of the fees. I also think that the "high fees," the evidence would indicate that fees have come down over the last 25 years in a very material way, and so, I do not know where Mr. Gensler—what his basis is of the high fees.

In our case with the lead director, I think it is very relevant because—and I will speak for our situation—it is a decision that the fund directors made on their own, and that is, they felt they wanted to have one of their people be the point person in effect working with the advisor, and in our case the lead director sees the agenda for the meetings beforehand, reviews that agenda, has comments, gets involved with some of our vendors, does various things that the other directors would want them to do, and performs in that function. He does not want to be chairman of the funds because—as the Chairman said—this is such a complicated business. He thinks it would be a bit of a charade to put a part-time independent director in the chair's seat and pretend, in effect—and I think you alluded to this in your opening comments—it gives an impression of a lot more authority and power and independence and knowledge than frankly exists. And that has been the reaction to all of the suggestions from our independent directors.

Senator SUNUNU. Mr. Phillips, in your recommendations, I think you recommend disclosing fund manager compensation. I have not worked in the investment industry, but I am very pleased that I have some private sector experience working for a small manufacturing firm, so in theory, I am still employable after I serve in the U.S. Senate.

[Laughter.]

But it would seem to me that in the private sector disclosing key compensation beyond which is required in the 10(k)'s, executive compensation but disclosing other key employee compensation, unless it is applied in a very, very broad and uniform way, would put funds at a tremendous competitive disadvantage relative to money managers and private banking, at hedge funds, and investment banking, that can just go right down the list and find those fund managers that they think have performed well or have unique sets of analytical or other skills, and on the basis of this information, pick them off.

Mr. PHILLIPS. Senator, it seems to me that there is an obvious template for this. Publicly traded companies, the key officers are—their full compensation is disclosed. We know to the penny what Michael Eisner is paid to——

Senator SUNUNU. Executive compensation is disclosed in a 10(k). I do not know if it is the top five paid or the top 10 paid, but that is for all public companies 100 percent.

Mr. PHILLIPS. That is correct. And every day we talk with fund managers who say before they buy stock in a company they look and see how management incentivizes. They like to see how much is in base pay, how much is in bonus, how much is in stock compensation. In fact, I have spoken to fund managers who have commented on Mr. Riepe and said how much they like T. Rowe Price's bonus structure and where their senior executives have a low base

salary and get most of their compensation in bonuses and have significant stock options.

So, it seems to me, why shouldn't fund investors have that same kind of information to know whether a fund manager's compensation is linked to sales, new sales of the fund or simply to performance, or is his or her bonus tied to short-term raw performance or longer-term risk-adjusted performance? Is it tied to pre-tax or post-tax returns? If you are an investor thinking about buying a mutual fund, and you are thinking about putting it into a taxable or a non-taxable account, would it not be significant to know if the fund manager's bonus is linked to pre-tax or post-tax returns?

The notion that it would put the fund industry at a significant disadvantage to hedge funds and other types of money management, I think to buy into that argument you would have to say that publicly traded companies are at a significant disadvantage to privately managed ones, because all of the good managers want to go run privately managed companies so that their compensation would not be disclosed publicly, and I do not think anyone would buy that. Obviously, we are able to get very talented and good people to run publicly traded companies even though that comes with the burden of having your salary disclosed, the same way we can get people to run for the U.S. Senate, even though it comes with the burden of having a significant exposure to your personal income taxes.

It seems to me that all investors have a right to know if their interests are aligned with management's interests. We have a great template for that with publicly traded stocks, ones that fund managers take advantage of, but then those managers turn around and do not give the same significant and valuable insights to their shareholders.

Senator SUNUNU. If I am buying aluminum siding for my home, should the company be forced to publicly disclose the compensation package for the salesman who is selling me the aluminum siding?

Mr. PHILLIPS. I do not think that mutual funds are a product. There is not a fiduciary responsibility that goes with aluminum siding. There is a fiduciary responsibility that goes with the management of mutual funds.

Senator SUNUNU. You talk about making directors more accountable to shareholders. Can you offer some specifics there, how that might be accomplished?

Mr. PHILLIPS. Yes, absolutely. To me, again, the visibility is the much more significant issue than the independence. As I mentioned in my oral testimony, one of the disturbing things that organizations like Putnam—which has a very visible board and a very strong board—is whether whistleblowers at Putnam, none of these whistleblowers thought to go to the board. My point is that mutual funds' boards have been out of sight and out of mind. In fact, you saw that in last Friday's *Wall Street Journal,* where there was a letter to the editor in response to Ned Johnson's editorial, looking for—stating that independent directors are good. The woman who wrote the letter back was clearly confused. She thought that a dependent director was one who owned shares in the mutual funds, not one who also owned the management company.

What we have suggested is to have front and center the identity of the directors. Right now the identity and the role of the directors is in the statement of additional information. What we have asked for is to have a statement at the beginning of the mutual funds prospectus that says something along these lines: When you buy shares in a mutual fund you become a shareholder in an investment company. As an owner, you have certain rights and protections, chief amongst them an independent board of directors whose main role is to represent your interests. If you have comments or concerns about your investment, you may direct them to the board in the following ways.

As I share in my testimony, I have met a number of independent directors over time, and they have very little contact with fund investors. I met one gentleman who was on the board of a number of mutual funds and also on the board of a Fortune 500 company. And he told me as a member of that Fortune 500 company's board, he received about a dozen letters a month from shareholders, and he said he did not respond to every one, but he read every one. He said over time they made him a better director. But he said in 10 years of being an independent director at a mutual funds complex, he had never once received a single letter from shareholders.

My simple question is: How can these people be the voice of shareholders if they do not hear from shareholders?

The other thing that we would ask for is that the chairperson write back to investors in the annual report each year to simply discuss how they reviewed the management contract, what concerns they had, what actions they took on shareholders' behalf for that year to create some more visibility for the board so that the board can truly fulfill its function.

Senator SUNUNU. Given that limited shareholder contact, are you supportive of the idea of mandating a disinterested chairman for funds?

Mr. PHILLIPS. I think that is more of a superficial solution than anything else, but the superficial and the symbolic things count as well, and I think it would be a step that perhaps would give investors some assurances that at least one independent director will be fully engaged in working on these. To me, one of the most disturbing things I have heard through the years are the extraordinarily disparaging remarks that fund industry officials will make about the independent directors. I have been told repeatedly that the biggest challenge is keeping the independent directors awake at the meetings, and as long——

Senator SUNUNU. I am sure that is not true.

Mr. PHILLIPS. You hear it regularly. We have to get these people engaged. I really believe that there is something about the corporate structure of funds that has made the mutual funds industry in the United States a better industry than the mutual funds industry anywhere else in the world. So the boards have done something right. If we are going to keep the boards, if we are going to have the cost of boards, let us make sure they are front and center in the public's mind so that they truly can fulfill that function.

Senator SUNUNU. Thank you.

Thank you, Mr. Chairman.

Chairman SHELBY. Senator Carper.

Senator CARPER. I will yield to Senator Sarbanes.

Senator SARBANES. Thank you very much, Mr. Chairman.

I apologize to the panel if I ask questions which repeat testimony that has been given or other questions that have been asked, but since I was out of the room with the vote, I missed part of this.

The first thing I want to focus on is the—because there is a tendency to, I think, concentrate on the abuses for obvious reasons, I mean the most manifest abuses, and late trading and things of that sort. But I want to get some sense of the amount of monies that are involved in the broad picture, and therefore the importance of the mutual funds industry and its proper governance and how it works, just in a broader social setting.

Mr. Gensler, you say that the SEC noted the potential effects on retirement savings when they stated a 1 percent increase in a fund's annual expenses can reduce an investor's ending account balance in that fund by 18 percent after 20 years. In other words, as I understand that, over a 20-year period, say if you were in a fund that had a 0.5 percent fee as opposed to a fund with 1.5 percent fee structure. I know the former is pretty low, but I think there are some that are even beneath that point. That the difference for the investor after 20 years, it would be an 18 percent difference. Is that correct?

Mr. GENSLER. That is correct, sir.

Senator SARBANES. How much money are we talking about in the overall? Do we have any estimate of how much goes into the fees?

Mr. GENSLER. Senator, you ask a very good question. There are various estimates, as I outlined in the testimony. If you take the average fees, annual expense ratios, which if you just average is between 1 and 1½ percent, and I will even use the 1 percent to be at the low end, add in the burden of the constant trading of the portfolios with the typical fund—I will use the median fund—turns over their stock once every 18 months. And to that add another half a percent if you add the commissions and trading costs and so forth. About half of all funds have sales loads, and if you take the average holding period that all of a sudden adds costs. Then in addition, believe it or not, we are triggering a lot of short-term capital gains taxes, and that may be good for the U.S. Treasury, but this hearing is about promoting savings in America, and mutual funds do, unfortunately, trigger a lot of short-term capital gains that add 1 or 2 percent to the cost instead of the long buy and hold strategy. So overall an investor can be looking at an additional 3 to 4 percent, not just on expenses directly to the mutual funds, but between the triggering of these additional costs and the trading costs and the like.

Now, there are various estimates how much that means to the mutual funds industry. I estimated approximately $100 billion a year between the mutual fund industry and the brokers and financial planners. There have been other estimates, but these are significant dollars, and as I said in my oral statement, I think this hearing and why I am in the reform camp if I am, is to promote retirement savings in America. I think that is really why governance matters, is can we best promote retirement savings?

Senator SARBANES. Presumably, no one at the table is in favor of setting up some kind of mechanism to set fees, to regulate fees.

Mr. GENSLER. No. Again, I am not for that.

Senator SARBANES. I understand that. So, you have to think what structures in the industry would contribute toward lower fees rather than higher fees. Or let me put the question another way. Why is it that some very successful funds have low fees and other funds have very high fees, and what is missing in terms of addressing this discrepancy? I take it one position—I think this is yours, Mr. Glassman—is well, that is just how things are and it has to play itself out. Would you take that view?

Mr. GLASSMAN. Well, I would not say that. I would say that funds, especially load funds, which charge the higher fees or charge the up-front commission, are providing something to investors, especially kind of novice investors or investors who really do not have that much experience or who do not want to spend that much time making choices, they provide an extra service which people are willing to pay for. I think that is the best explanation.

I would also say, as far as how to lower fees, I think that one thing that we have kind of lost sight of, Mr. Gensler was talking about independent directors setting—or independent chairmen setting fees. Fees are set by supply and demand. Prices are set by supply and demand, especially in a vigorously competitive industry like this. If you want to lower fees, what you need to do is increase supply. In other words, try to get more funds to participate, or you can lower demand, in which case make all the funds do a terrible job of providing service to people. Funds provide a good service so that is why people pay for it.

Senator SARBANES. Is there not a basic issue, right at the outset, of disclosure in terms of full information? How does an investor, a prospective investor, make a wise decision if they do not have full information? I think that was one of the points you were stressing.

Mr. GENSLER. I think there is one piece of information that is still absent, portfolio trading cost. This industry does have exhaustive disclosure and I would not be for a lot more, but that one piece would be critical. Just to clarify, Mr. Glassman, I do not believe that independent chairs should set fees, nor to Senator Sununu, I do not think it is a silver bullet. I think directionally it probably will change the tone in the boardroom. I think more fundamental is, we have a structure now, and do those boards weigh in to the negotiation of fees? I do not think there should be requests for proposals and changes——

Mr. GLASSMAN. But I mean you agree——

Mr. GENSLER. —weighing in to this negotiation——

Mr. GLASSMAN. —that any business wants to charge the highest price that it can possibly get. Let us not kid ourselves. That is what capitalism is all about. You are constrained in the price that you can charge basically by whether people like the product that you are selling and whether you have lots of competition. That is how prices occur. Information is tremendously important, Senator Sarbanes. You are absolutely right.

Senator SARBANES. Well, what do you think the role of the directors is?

Mr. GLASSMAN. I said earlier that I think it would be a good idea to take a look at whether the structure of the 1940 Act really makes sense today. Senator Sununu was asking the question about

aluminum siding, and I think Mr. Phillips said that mutual funds are not a product. I can tell you that my readers would be shocked to learn that. They think mutual funds are a product. They do not think that they are investing in a company and that there are directors and that there——

Senator SARBANES. Do you think that the directors have a fiduciary duty?

Mr. GLASSMAN. Absolutely.

Senator SARBANES. You do?

Mr. GLASSMAN. Absolutely.

Senator SARBANES. Do you think that the current fiduciary duty standard is adequate?

Mr. GENSLER. I do not think so.

Senator SARBANES. Mr. Glassman, do you think so?

Mr. GLASSMAN. I have to say that that is not an area where I really have any expertise, but absolutely it is——

Senator SARBANES. I mean that if you look at the standard established in the Gartenberg case, it is totally inadequate in terms of providing some rational standard of fiduciary duty, is it not?

Mr. GLASSMAN. I do not know that case, but I really do think that an examination of whether the current structure——

Senator SARBANES. But you do think they have a fiduciary duty?

Mr. GLASSMAN. Every director has a fiduciary duty to his shareholders.

Senator SARBANES. Then the standard of that fiduciary duty would become a highly relevant question, would it not? You could say, well, you have a fiduciary duty but you might have a court decision which defines that fiduciary duty at such a low level that it does not amount to a fiduciary duty compared with other prevailing standards for fiduciary duty. Would you concede that the standard at which the fiduciary duty is set is, of course, a very important and relevant question, is it not?

Mr. GLASSMAN. Absolutely, but I think the question is whether that duty is owed to individual shareholders in one of 8,000 funds, that is 8,000 separate companies. Let us remember this. Or whether it should be owed to the shareholders in the management company that in real life actually runs the funds. We all know that. We are kind of pretending that something else is going on here. This is what investors think. When they buy a fund from T. Rowe price, they think they are buying it from T. Rowe Price.

Senator SARBANES. Therefore, you think that the fiduciary duty that the directors of a fund owe is not to the investors in the fund, but to the shareholders of the management company?

Mr. GLASSMAN. I think under the current structure, quite clearly it is to the investors of the fund. All that I would encourage this Committee to do is to look into whether that really is the best structure, the most rational structure, in fact, the kind of structure that investors need.

Senator SARBANES. If you are going to shift it to the shareholders in the management company, who is going to exercise fiduciary duty with respect to the investors in the fund?

Mr. GLASSMAN. I think that investors buy individual products, financial products, and they make the decision about the brand, the company that is selling them that product. All I am saying, I am

raising this issue which others have raised about whether it makes sense to—I would call it certainly antiquated and it may even be kind of a fiction that these are individual companies. People do not look at it that way.

Senator SARBANES. I know my time is up.

Mr. Phillips, Morningstar looks at all these funds. Do you have any comment on this issue?

Mr. PHILLIPS. I would say that people do not look at this that way because the industry has not treated them that way. The industry has lived perhaps by the letter of the 1940 Act, but not by the spirit of the Act, and the word "product" does not appear in the 1940 Act.

I would say as far as fees, we have to engage investors at a level that they are going to be capable of participating in the debate. All other professional fees, even the taxes that you pay——

Chairman SHELBY. What is that?

Mr. PHILLIPS. To state these fees in dollars, all the other professional fees.

Chairman SHELBY. I mean what is the standard that they are going to be able to participate?

Mr. PHILLIPS. What I mean by that, sir, is that investors do not relate to percentages or to basis points, but they relate to dollars. Taxes may be calculated in percentages, but if you look at your paycheck, it is stated in dollars, the number of dollars that are deducted for Federal taxes, for State taxes, for Social Security, et cetera. That allows an informed debate over whether these are at a fair level.

Investors are used to looking at dollar fees that they get from other professionals, from their accountant, from their dentist, from their doctor, and that allows an informed debate. But when it comes to mutual funds fees, these fees are never presented in dollars, and that keeps the investor disengaged from an active debate over whether they are getting good value.

Chairman SHELBY. Is this by design?

Mr. PHILLIPS. I do not know if it is by intent, but it certainly is by the way that the fees are collected, as Mr. Gensler pointed out, and my suggestion would be simply let us level the playing field here so you can engage investors to have an informed debate. I do think investors over time move to lower cost funds, but not because they have had a thorough examination of the cost, but simply because they have seen the——

Chairman SHELBY. They move to funds that may be lower cost, but they also move to funds that perform.

Mr. PHILLIPS. That is a very good point. At the end of the day investors do not simply want the lowest cost.

Chairman SHELBY. So the market will work if the people have choices maybe.

Mr. PHILLIPS. That is right. They want the best returns. I mean the way to pay the lowest taxes is to have no income. You do not want to look at one of these things in isolation, cost alone.

Chairman SHELBY. You could have a fee, a little more expensive fee, and you could have better managers and, gosh, if they produce, people will pay as long as the people know that. Would they not, Mr. Glassman?

Mr. GLASSMAN. Absolutely. I do not think there is a single reader that I have who would not rather pay a much higher percentage fee——

Chairman SHELBY. For performance.

Mr. GLASSMAN. For performance. And look at hedge funds. These are very sophisticated investors. They are willing to pay on average one percentage point plus 20 percent of the profits. Now that is a great deal higher in a year in which stocks perform, as well as they did let us say last year, than what individual investors pay. So it is not so unusual that people are willing to pay a lot. The problem is, obviously, that when you just look at short-term performance and extrapolate that out, then you could be making some very bad decisions as investors, and that is one of the great roles that Morningstar plays in providing that information to people so they do not make those decisions.

Mr. PHILLIPS. If I could point out one difference, investors see the benefits. They see the returns in dollars but they do not see the cost in dollars. If you see both in dollars, then you will have a more informed debate.

Mr. RIEPE. Actually, to answer your question directly, they are in percentages because returns are expressed in percentages, and that is how people look at returns. They look at was I up 12 percent last year, did I earn 6 percent, was I up 18 percent? So putting expenses in the same mode is why expenses have historically been expressed as an expense ratio.

One of the big successes in mutual funds has been that it is an agency product, i.e., nothing is promised to the investor as it might be in an insurance product or a bank. It is transparent. You are going to get the return we earn minus X percent, and that is the way it is.

Chairman SHELBY. Well, could you perhaps come up with some solution that the fund would disclose a percentage and this percentage would equal so many dollars?

Mr. RIEPE. Yes, the SEC has proposed that.

Chairman SHELBY. That way you have some numbers.

Mr. RIEPE. Right. The SEC has proposed that. Certainly, we are all in support of it. And our only argument was don't put it in absolute dollars relative to your balance because then I as an investor can't compare it to anything. So, I open up my statement and it says, you know, it cost you $742.17 last month. I don't know what to compare that to. What the SEC has proposed, which I think is very reasonable, and what we have certainly supported is do it on a $10,000 payment.

Chairman SHELBY. What do you mean you couldn't compare it? You can compare costs to anything if you have the model.

Mr. RIEPE. Well, but not other funds. In other words, if I own three funds and I have $7,000 in this and $3,500 in this and $12,500 in this, I can't compare dollars. I can compare percentages. Of these three funds, if one has a 1.5 percent expense ratio, another has a 1 percent, and another has an 80-basis-point expense ratio, I can compare the cost. But if you send them to me in dollars——

Chairman SHELBY. But if the factor is carried out into dollars from percentages, you could figure it.

Mr. RIEPE. I can tell you the absolute dollars. It is a question of you can't compare that to anything else in terms of comparing to other funds. And I think Don agrees with this as well.

Chairman SHELBY. But as a mutual fund owner, you would realize the cost, though, maybe in some way.

Mr. RIEPE. Yes.

Chairman SHELBY. I am just trying to learn.

Senator Carper.

Senator CARPER. I did not have the benefit of hearing Mr. Gensler's or Mr. Glassman's testimony, and what I am going to ask each of you to do is take a minute apiece just to recap briefly what you most want us to take out of this hearing having heard.

Mr. GENSLER. Thank you, Senator. And it is good to see you, too, Senator Corzine. My former boss. He sent me to Japan.

Senator SARBANES. We will be very mindful of that as he asks questions and you give answers.

[Laughter.]

Mr. GENSLER. I think that this entire debate about mutual funds really relates to retirement savings in America. We have so many debates about Social Security and Medicare and how we provide for the retirement of the baby boomers. Well, the good news is mutual funds are right at the center of that. They are a product that has served so many Americans so well. But if we can look at the policies around mutual funds to have them serve Americans even better, I think that is the challenge really moving forward. And in that light, I think at the core is we have a governance system that was put in place 64 years ago by Congress, recognizing inherent conflicts that are not going to go away. Those conflicts will be there again 65 years from now.

Can we help the balance in that boardroom? It is not a silver bullet to have independent chairs, but that is directionally, I think, a positive step. I think more important is the fiduciary duty that those directors are held to. Are they engaged in representing the shareholders? As Chairman Donaldson said just 2 weeks ago, "The fund board of directors serves as the shareholders' representatives in this negotiation." He was referring to the negotiation with the investment adviser. Can we really instill in them as gatekeepers to be involved in that negotiation? Not to go out and get requests for proposals and change fund managers, as some have said. I am not for that. But just to be really shifting that balance a bit in that boardroom.

I also think it is worthy to look at restricting or even repealing 12b–1 fees. I think that they have served their length of time. They haven't really served the purpose they were first attributed to. Last, disclosing portfolio trading costs. Those would be my three key takeaways.

Senator CARPER. Thank you.

Mr. Glassman.

Mr. GLASSMAN. Thank you, Senator Carper, for this opportunity. Just briefly, my main message is that I urge you to proceed extremely cautiously, which the Chairman said that he would be doing, you would be doing. I said that mutual——

Senator CARPER. He always says that.

Mr. GLASSMAN. He always says that.

Senator CARPER. You usually do.

Chairman SHELBY. Cautious but thorough.

Mr. GLASSMAN. Right. I reminded you that the mutual fund is the most successful financial vehicle of all time. In the last 30 years, it has gone from $48 billion in assets to $7 trillion in assets. And we really shouldn't do damage to something that has been so successful for individual Americans and for the economy.

I also talked about how investors have disciplined funds that misbehaved and have been accused in these scandals, as they should, and the discipline has been very harsh, as it should have been. Twenty-nine billion dollars in assets were withdrawn from Putnam. I have a table in my testimony. Meanwhile, untainted firms—American, Vanguard, Fidelity—gained a total—some of the untainted firms, not mentioning all of them, gained a total of $133 billion in assets.

Then I responded to specific proposals. I oppose the hard 4 p.m. close because I think that hurts small investors. I oppose a mandatory redemption fee because I think that discourages exit, and you want exit from funds to discipline the funds. I oppose proposals on independent directors and instead urge an examination of the current legal structure of funds to see whether it really makes very much sense to have 8,000 separate boards of directors. And the same thing with the composition of fees. Why do we have to go into such great detail about whether this is ascribed to 12b–1 or this to management costs? Just simply make clear what the prices are and let individuals make those decisions.

What else? And then I emphasized that really what is needed is investor education. I see that every day. I think most of my readers are fairly well-informed, but more and more Americans are entering the arena of investment, and that is great. Just as Mr. Gensler is saying, this is really a retirement issue, and they need better education. I think that is where a great deal of your emphasis should be directed.

Thanks.

Senator CARPER. The panel before us today is a diverse panel with diverse views. Out of that diversity, our responsibility is to try to develop some consensus. It would be helpful to me to ask each of you—and we will start with our State Treasurer, but just to share with me maybe a thought or two, as it were, where you see some emerging consensus from among the disparate testimony that we have heard today.

Mr. BERRY. Well, I think certainly there is some consistency that this is an issue that we all must deal with. I think there is consistency that there are more and more people entering into the mutual fund arena. Because of tax advantages that have been provided for investments for retirement, et cetera, more individuals are in the mutual fund environment, and as a result, we need to make sure that we are able to provide clear, concise, consistent reporting to those investors of what they are seeing and what they are paying for. There is some inconsistency here as to how that is best achieved, but I think we all have the goals and desires to provide that clear, consistent reporting.

Certainly, I think investor education is something that we have heard from several individuals, that because more individuals are

participating in the marketplace, we need to make sure that those individuals have access and are obtaining the education necessary and are not more confused by the process, and that through this whole process we do not do more harm to our investors, that we ensure that we provide more clear, consistent disclosure.

Senator CARPER. Okay. Thanks.

Mr. Riepe.

Mr. RIEPE. Senator, I would say, number one, that I think there is a very strong consensus that the mutual fund as an investment vehicle for Americans has proven to be a very successful and transparent—which is one of the reasons it has been successful—product for them. And it has given access to the markets in a very cost-effective way. I don't think you can fool 90 million Americans for all these decades. There is no question about that.

Senator CARPER. Some of us have tried.

[Laughter.]

Mr. RIEPE. Yes, certainly.

Senator CARPER. Remember what Lincoln used to say? You can fool all the people some of the time.

Mr. RIEPE. Right, some of the time.

Senator CARPER. Some of the people all of the time.

Mr. RIEPE. I find it kind of interesting that most of the testimony and comments have stayed away from the abuses, which is comforting to me in the sense that I think there is a general sense that the abuses are being dealt with by the SEC, by the prosecutors, et cetera. This has now sort of opened up the opportunity to make broad comments on mutual funds generally that are really off the subject of the abuses. But I think the good news is that those abuses are being dealt with, number one; and, number two, the marketplace impact on those involved has been enormous, and that is the most powerful signal that you can send to all the others in the marketplace. Number three, I think there seems to be a general consensus that the SEC is doing what it should be doing, being very aggressive. Whether it got a late start or not, I wouldn't get into any of that, but certainly as a receiver of all these reforms and initiatives that they have put out, this is the broadest and most comprehensive I have ever seen.

I think the disparity starts to come into a fundamental misunderstanding of funds, and I think in your future panels you will talk about this a little bit more, and so I won't get into it today. But somehow people are dealing with funds as if they are these independent entities that sit out there. But the fact is they have to be created, and they are created by an adviser—and I think Mr. Glassman alluded to this a little bit. They are created by an adviser. They are created by an adviser not for philanthropic purposes. They are created by an adviser as a way to package their investment skills and put out into the marketplace. If they are successful and they deliver a good performance, they grow. If they do not deliver good performance, they don't grow. Then when they do grow, somehow, because of this corporate structure the investment companies have been placed in, they now take on a life of their own. And that even leads to what Gary alluded to of some people suggesting that you should go out every year for RFP's, which I know he opposes.

But I think one has to remember that you don't go to bed at night with a Chevy in your garage and expect six or seven or eight or ten directors whom you don't know to pick a Ford for you and there is a Ford there the next morning. That is just not the way the system works. People have hired T. Rowe Price, people have hired Fidelity, people have hired the American funds because they have done their homework and that is who they want to manage those funds. The system that we have to work around that is the system that most of the discussion has been about today, not about the abuses.

Senator CARPER. Mr. Phillips.

Mr. PHILLIPS. Thank you. I think there is agreement that mutual funds are a terrific investment vehicle. Even Jack Bogle, one of the harshest critics of the industry, was quoted in *The New York Times* recently as saying, "There exists in the mind of man no better vehicle for long-term investing than the mutual fund."

I think there is also agreement that the fund industry occupies a privileged space, being the core vehicle for things like 401(k) plans, 529 plans, individual retirement accounts.

I believe that there is also agreement that the industry has misstepped. Even the most senior people in the fund, members of the ICI, take the abuses that have happened at some fund companies extraordinarily seriously. And I have seen fund executives personally affronted by how serious some of these transgressions have been. So there is a sense that the industry has in some cases lost its way a bit.

I think there is also a consensus that we should be looking forward to say how do you, like the framers of the 1940 Act, think about this industry in broader terms and put it on sound footing that it can be protected, not just for the next 6 months but for the next 60 years? And I think that is what has opened up the dialogue beyond just dealing with the most recent abuses, but instead thinking mutual funds have become so central, as Gary has said, Mr. Gensler has said, to the retirement savings that we have to be thinking longer term. How do we protect this industry? How do we make a good thing even better? That is what has encouraged the debate on how to do that. I think everyone is in agreement that this is an important issue and it is one that we need to be thinking long-term about. There is just disagreement to some extent over what is the right way to do that.

Some, like Mr. Glassman, are saying let's get rid of the structure that has protected this industry for the last 60 years. The corporate structure, in effect, is a farce. Let's treat these as products. To me, it seems that there is something about the corporate structure that has protected this industry. As I say, we track mutual funds in other countries where they are not organized as corporations. They are organized truly as products. They are organized contractually. There you see real abuses, and you can see why. If someone is writing the contract, giving it to someone else to sign, they are going to tilt that contract as much as possible in their favor.

I think there is something about the corporate structure that works very well and has served investors well. And I think it would be wise to consider strengthening as opposed to abandoning the corporate structure of funds.

Senator CARPER. Again, Mr. Gensler and Mr. Glassman, my question is: Where do you see the consensus?

Mr. GENSLER. Consensus that this is critical and important to retirement savings. Consensus that there is a need for reform. And I applaud actually the industry, the ICI. Unlike some other industries, this industry actually is engaged in a constructive dialogue of reform. The distinctions are—and even agreement that governance matters. The distinctions are does Congress need to do more after the SEC completes its rule writing by the spring and whether we need to enhance what goes on in that boardroom around governance. And you know where we all stand, but I think those are the key differences.

If you say no, then maybe Congress doesn't need to act. If you say yes, then Congress needs to go further because the SEC doesn't necessarily have the authority to address itself to those fiduciary duties in that boardroom.

Senator CARPER. Thank you.

Mr. Glassman, the last word.

Mr. GLASSMAN. Just let me make a comment on an area where we do differ. Mr. Phillips was saying that I am in favor of throwing out the corporate structure. I am not. I am in favor of reexamining it. I refer the Committee to an excellent article in *Business Week* on November 17, called "Funds Need a Radical New Design." I think we really need to look at that question.

I want to just go back to where I think we all agree, and the most important thing, quite frankly, is investor education. Even in the current scandals, Morningstar took the lead in telling its—in elucidating this and telling its readers that perhaps they shouldn't be investing in some of these funds. I did the same a little bit later. I told my readers that they ought to specifically dump several of these funds.

We need, however, much broader investor education. The SEC does it or is supposed to do it. The Treasury Department does it. The Labor Department does it. There is very little coordination, and there is very, very little money. The mutual fund industry had done, quite frankly, a fantastic job of educating a lot of newcomers to investing. But I really feel there is a major role for Government here, and it ought to be played, and I think the panelists agree with that.

Senator SARBANES. Mr. Chairman, at this very point I ought to interject that the issue of financial literacy has been a subject in which Members of this Committee have been extremely interested—Senator Enzi, Senator Corzine, Senator Stabenow, and myself, and, of course, the Chairman. In fact, we included in the Fair Credit Reporting Act reform legislation a financial literacy and education title that establishes a commission at the Federal level of all the interested agencies and departments to develop a national strategy with respect to financial literacy. They just had their first meeting 2 weeks ago. The chairman of that commission is the Secretary of the Treasury, and he was there. I think there were three or four Cabinet officials present at the initial meeting of that commission. And the Chairman of the Federal Reserve, Chairman Greenspan, was also there.

I think it is important, just as you indicate, and I wanted to get on the record at this point, because I thought it was highly relevant, the action by this Committee and subsequent action by the Congress and the signature by the President and this commission is up and going.

Now there is a vast field that has to be covered on financial literacy. You have payday lending and predatory lending and so forth and so on. But obviously we need to raise the standard of literacy amongst the American public.

Chairman SHELBY. That is good.

Senator Corzine.

STATEMENT OF SENATOR JON S. CORZINE

Senator CORZINE. Thank you, Mr. Chairman, and I congratulate you and the Ranking Member for leading a most thoughtful discussion on this topic, which is at the heart of the savings function in this country and retirement function. And I am one that believes that the SEC is doing a terrific job in actually addressing a lot of the issues at hand. That does not lead me to believe that there is not room for legislation. I think capturing some of these reforms is really about revising the 1940 Act, and it is a wise piece of legislation, but I think terms and conditions of the marketplace have changed pretty dramatically, and we should really do a top-to-bottom review.

I apologize to the panel for being late. There are a number of hearings going on today. But this is as important a set of issues, I think, for savers in America that we can get to.

Part of the discussion I hear, though, is trying to put things in either/or context. We are either going to have percentage fee disclosure or we are going to have absolute dollar disclosure. I don't really understand why you can't have both. I think people are smart enough to actually use all of that information.

I don't fully understand why distribution fees and management fees are fair game and transactions costs aren't fair game, and people understanding whether their mutual fund is performing effectively. By the way, turnover in those accounts has a lot to do with the ultimate after-tax performance, so I think we are not serving the broadest public if there are 95 million folks. I wish I understood all of the tax implications of all the strategies that are going on in these mutual funds, but I don't think it is quite obvious to most people. And I would be concerned if we didn't address or at least the SEC didn't address some of these things, and I think full fee disclosure and transaction costs are something that need to be addressed. I haven't heard the words "soft dollars" mentioned since I have been here. Maybe they were talked about beforehand. But there are tremendous implications, I think, for a different cost structure and performance for individuals that should be understood, and it doesn't mean that people won't look at their total return over a period of time. You ought to have a right to understand what you are paying to get the results that you are.

There is a serious issue that a lot of you have apparently pointed out on the legislation that Senator Dodd and I introduced earlier on the hard 4 o'clock close. I think actually we need to listen to the industry and figure out how we can get some facilitating device to

have small investors be able to move through that process in a way that doesn't look at hard closes. I am curious whether anyone would want to comment on some of the intermediary devices, national clearing corp or some auditable outside vehicle being able to certify that we are not into late trading, market timing, and all the other kinds of things. Is that a practical solution? It seems to me that edging along those lines as opposed to either/or on the hard 4 o'clock closes is a more appropriate response.

Let's see. Also, I continue to be troubled—and I am absolutely not—absolute certainty about this governance issue with regard to whether you have a board of directors that governs the management company or each of the individual funds, because you can get a proliferation of boards that might be hard to imagine that you will be able to staff appropriately. But from my own point of view, I can't imagine that the board doesn't have a fiduciary responsibility to the investors. It strikes me that making sure we engineer our responses along on the governance issue are pretty important, and, again, I am not sure we want to put it in an either/or status.

Finally, I have serious concerns about mixing up hedge funds and mutual fund managements. I understand these fee structures, and if my brain were trying to somehow sort out without ever verbalizing where my good trades go versus my bad trades go, no matter how perfect a human being I might be, I think that there is an enormous incentive that needs to be recognized in how we are managing, which is another one of the topics that need to be put forward here.

I would love to hear your views on some of the things that I am talking about. I really don't understand why we are so either/or, particularly on fees and costs, which I think can be informative, ties into the financial literacy and investor education. People ought to understand what is actually transpiring, why they are paying to get the results that they are getting, and I don't know why more information clearly stated isn't a good idea.

I guess I am making more of a statement—but I would love to hear comments about third-party verification on 401(k) investments. I would love to hear views about the debate about whether you have an independent board of directors at a fund management group or it has to be at each individual. I would like to hear about the hedge fund concept. I think we are all in agreement on this financial literacy or education effort. We ought to try to structure that in a way that is actually really practical for all of the various individuals. And anybody that wants to talk about soft dollars, I am always interested.

Mr. GENSLER. I will try to do it—knowing your list of seven, in 40 seconds. I think you can have dollars and percents. Some in the industry might be hesitant because the dollars could be a bit high.

Congress already acted before you were a Senator, but unfortunately, the after-tax results are not in promotional material or on your statements.

Soft dollars, I think there is some real problems of abuses there. I would restrict it. There is a legitimate question about independent research and whether you would ban it completely or you would find some way to narrow it to allow independent research, but really only independent research.

I sense I am where you are. I think the hard 4 o'clock close is too hard, and it is probably the one place Mr. Glassman and I are in agreement.

I don't have a problem with unitary boards, being that T. Rowe Price have one overall board with all these investors. That is efficient. It is a little awkward, maybe if you had a problem with one fund and not the other 80 funds. But I think governance is not about whether there is one. You can be efficient. Governance is about are they going to act in investors' interests.

Then hedge funds and mutual funds, I think the real issue is allocation of shares. So if you could adequately assure that trades aren't going to be cherrypicked for the hedge fund, but if you can't, that is the real issue is the allocation of shares.

Mr. GLASSMAN. Can I comment on a few of them?

Senator CORZINE. Can I ask a follow-up question?

Mr. GLASSMAN. Sure.

Senator CORZINE. Does that mean that you think there needs to be more transparency with regard to hedge funds? How would we be able to assess that if we don't know what the heck is going on?

Mr. GENSLER. Well, I think it is a question of the allocation of shares within a mutual fund complex, and we already have that issue, Senator Corzine, even amongst the mutual funds.

There is a benefit to allocate the hottest trades to the smaller funds because you can goose the performance of a new fund, an incubator fund, and then advertise it later in the year as hot. So this issue of allocation is not unique to hedge fund/mutual fund management. I think it is already in the mutual fund field, regardless of the hedge funds. It just adds to it and makes it harder for your hedge fund points.

Senator CORZINE. It is more complicated when you do not have transparency, however, with hedge funds.

Mr. GENSLER. If it is in the management of the same company. I didn't know if you were asking about general transparency of hedge funds that are not in the management of mutual funds.

Senator CORZINE. Multiple.

Mr. GENSLER. I don't think there is a need to bring nonaffiliated hedge funds into some global portfolio disclosure system. I think the market actually benefits from a very nimble group of investors, which we call hedge funds, and the economy benefits in a way that—and I haven't found a regulation that wouldn't hurt some of that on hedge funds.

Mr. GLASSMAN. Just three quick comments. On the hard 4 o'clock close, I am worried about what happens to small investors who are put at a disadvantage, and the answer is a comprehensive clearing house with some kind of time stamping. I think that could be done, with tremendous responsibility placed on the funds and every other participant. People have been chastened, so that would work.

On soft dollars, I am really worried about the whole research situation in the financial world in general. I think that as a result of previous legislation, we are getting less of it, and we ought to have more of it. Some of these proposals would really hurt independent research, and I don't think that is good.

Finally, on the issue of dollars versus percentages——

Senator CORZINE. If the research were productive in helping get to returns, why people wouldn't pay for it for what the cost of it is that they think is impacting their performance. Why do we have to do it in a system that is opaque as opposed to here is the money I am paying to get this research that is going to help me do a better job?

Mr. GLASSMAN. I think the system could be more transparent. I agree with that. But I don't believe that companies should be prevented from doing transactions in soft dollars as opposed to hard cash. I think that the firms can simply say here is the soft-dollar amount and we will allocate it this way: This is for the trade, this is for the research. A lot of companies are already doing that, and I think that is fine. But whether they want to do it with soft dollars or not, I think that really should be their choice. But transparency is a good idea. It is necessary.

Finally on transparency as far as percentages versus dollars, I agree, both is fine. But my worry is there is so much in the way of disclosure already. I know my readers are not paying very much attention. I agree with Mr. Riepe that to just get a specific amount of dollars on your statement is completely meaningless. You can't compare it.

Morningstar does a fabulous job using both dollar amounts and percentage amounts. They also do a very good job of showing the tax efficiency of funds, the turnover in funds. I mean, you can get all the information that you as an investor really need. Maybe there are little odds and ends that you might need otherwise, but I think that funds themselves have an incentive to provide that information.

The problem with requiring more and more disclosures is that I worry that people—first of all, I don't think anybody—not that many people read them. Second, there is this tendency to believe that, well, we have done the disclosures, that is all we need to do, we as policymakers. I am not against disclosure, but I really don't think it is any kind of panacea, quite frankly.

Mr. PHILLIPS. I would say something on soft dollars. To me it seems like double-dipping. If you are paying a management fee, you assume that the investment research, the trading systems, the office furniture, all these things that a money manager needs, are being paid through the money management, not through an artificially high trading cost. As for the independent research, Morningstar is a provider of independent research, and so my stance may surprise you some. But it seems to me, as you say, if it has value, people will pay for it. To me this sounds like a $400 bottle of wine that you would happily purchase on an expense account but you wouldn't be willing to pay for out of your own pocket. It seems to me that if the research truly has value, then someone paying their own money should be willing to set the market price for that as opposed to people paying with other people's money, which is what is happening today.

Mr. RIEPE. Senator, on the either/or, certainly from my point of view, I don't think it is an either/or. I think it is both. And as I mentioned, the SEC has already approved disclosure and shareholder reports of a dollar, it is just a question of how we do that.

The one complicating factor, which I think you are familiar with, is that more than half of mutual fund accounts are held in omnibus accounts. So the idea of moving from intention to execution in this area gets very complicated because a broker who has an account for somebody has all kinds of securities, plus four totally different mutual funds. And getting all that information and getting it personalized and into that thing is a very complex administrative task. I am not saying it cannot be done, but the devil is in the details on that one. There is no problem with either/or. I think that both are good.

With respect to the hard close, I said in my testimony essentially what you said. The industry backed the hard close at the time because when one thinks about that moment in time when the abuses came out, we felt that we had to take a very strong position to make investors feel that they were being protected. We also felt that this was much more an intermediary problem than it was a fund manager problem. And so the hard close is sort of the heavy solution to that.

I think an electronic solution, like a clearing corp solution, is the right solution. There are a lot of daily transactions in funds, but how long would it take to be developed? I think that ultimately has to be the solution, and that will avoid penalizing shareholders, 401(k) shareholders, and other people who come in. I think that the NASD has one that tracks transactions from the very point it is delivered.

Let me just say on the soft dollars, the industry has come out and said that we ought to clarify it, we ought to end third-party research. And the only thing I would point out to you, this is not just a mutual fund problem. All advisers have soft dollars, and we would not like to see just mutual funds regulated for soft dollars and all other advisers be left out of that.

With respect to independent directors—we talked about this, and I think the Chairman spoke to this. Independent directors are being handed responsibilities far beyond what they are capable of executing as part-time overseers. Everybody is directing to them responsibilities that they are worried about, asking them to certify things that they can't certify. I think that has to come out of your review here, that we have to have a clearer idea of what they are. They are fiduciaries, but the question is: What is contained under their fiduciary responsibilities? What responsibilities do they have?

Mr. BERRY. As relates to funds, I think it is necessary that both be provided. Not only do investors look at their performance based on a percentage basis, but also they look at bottom-line dollars and what do they have in their account today. That is expressed in dollars, and as a result, fees expressed in dollars would also be meaningful to them as well.

Senator CORZINE. I thank you all. I think that personally I have a strong sense that we also need to think about how information is presented so that it is comprehensible. It ties together very much with the education issue, and I don't know whether that is a legislative approach or we need to do it in some other format. Not only making information available, but also making it presentable in a way that people can understand it I think is a key issue.

Thank you, Mr. Chairman.

Chairman SHELBY. I have a couple more questions. I want to address them to Mr. Glassman and Mr. Gensler. I am not picking on them, though.

As we consider reforms and possible legislation to protect investors, I agree with all of you that we have to be sensitive to the additional cost that will be borne by the investors. How do you do a cost/benefit analysis to determine when necessary reform becomes overregulation that costs investors? Mr. Gensler? That is something we have to weigh.

Mr. GENSLER. I think that it is a very difficult matter for policymakers and for Congress in all sectors of the economy.

Chairman SHELBY. Don't overkill, right?

Mr. GENSLER. Don't overkill. I mean, we do have a wonderful capital system in America, and it is part of our great success over the years.

I do think that in this area what some of us are suggesting in terms of having stronger board governance, meaning that these individuals are doing exactly what Chairman Donaldson has said, being engaged in that negotiation or that fundamental relationship is critical.

Might it add cost? Might these directors feel they need an adviser or something? It is possible. But when you are talking about $100 billion of costs, if they were to negotiate even 5 percent better, it would, I believe, cover that.

Chairman SHELBY. So when you reference in the cost/benefit analysis, if it is a cost, somebody has to pay it. Ultimately, the investor will pay it, will he not? It will be part of the overall deal.

Mr. GENSLER. Oh, I think that there are two areas, and ultimately it would be the fund companies that would probably bear the crux of many of my recommendations and the Wall Street that I used to work for that would bear the crux. I mean, if the system was more efficient and investors had higher returns, in essence if we narrowed the gap between where corporations borrow money and investors get a return, that narrowing in economic terms helps the economy. But it is the intermediaries—Wall Street, mutual funds—that would probably have lower profit margins. That is why they would not necessarily endorse what I am saying—and rightly so, they would not endorse. They have shareholders as well.

So, I think it is actually in narrowing that gap in the capital markets is where I would focus my attention.

Chairman SHELBY. Mr. Glassman.

Mr. GLASSMAN. I think if you raise the costs for everyone, then the costs to investors will rise. I think that is a pretty basic economic tenet. If you only raise it for certain companies, fine. They will go to the other companies.

You raise a very important issue, Mr. Chairman. Even on disclosure, disclosure costs money. You have to have the accountants. You have to do the publishing. You have to have lawyers. And it is a very important issue——

Chairman SHELBY. You have to ask yourself, will this benefit? Is this worth what we are doing?

Mr. GLASSMAN. Right, what is the benefit? In fact, I think we need to define benefit here. To me, and to most of my readers, benefit is a higher return on their investment. That is what a benefit

is. And will they get a higher return or a lower return through these disclosures? Well, it may be hard to say. My guess is they will probably end up with a lower return because they already have vast disclosures. This is just marginal disclosure that probably won't help.

Chairman SHELBY. Okay. Last, what do you believe is the most critical information for an investor to consider when purchasing a mutual fund? How can we make sure that investors get that information? Information is important.

Mr. Riepe.

Mr. RIEPE. I think there is just a few—it was interesting. Don said something ought to be on page 1. Every time I get into disclosure discussions with people, everybody wants it on page 1. You would have a page 1 that would fill up this room, probably. What we need to do is to make sure investors understand some fundamental things:

Number one, the investment program that they are buying into of that fund. What is the investment strategy? What kind of fund is it? Number two, what are the risks that come along with that investment program? These two things will overwhelm costs, fees, everything else.

Chairman SHELBY. But should the risks be stated up front and not footnoted back somewhere where nobody is going to read it?

Mr. RIEPE. Absolutely. Now, the risks get stated in words, but they absolutely should be stated up front.

Number three, what are the costs associated with buying into this investment? Then you get beyond that, and to me that is the top tier sort of—I am not saying that is all someone should know, but too many people don't even know those three things.

Chairman SHELBY. Anybody have any other comments? Mr. Gensler, what else should they know?

Mr. GENSLER. I would say on the risk aspect, there is a way that sophisticated investors look at risk, and it is called risk-adjusted return. I think that that would be the way to take those words, if somebody wanted to get it to page 1, and actually share with investors risk-adjusted returns.

Chairman SHELBY. Is that risk versus return?

Mr. GENSLER. Without getting into the calculus, it is a way to bring that return and adjust it for higher risk or lower risk.

Chairman SHELBY. What Mr. Glassman says, you know, we have a capitalist economy. You are investing for profit.

Mr. GENSLER. That is correct.

Chairman SHELBY. You have growth in there, so you know there is some risk—some risk everywhere when you put your money in.

Mr. GENSLER. Right, but there is——

Chairman SHELBY. Versus the return that they hope to make. Is that correct?

Mr. GENSLER. Right. But just in that one small place, there is a different risk of a Treasury bond than of an Internet stock. I think to your question, the most important thing for investors to do is first, on their own, without all of this information, decide how comfortable they are in stocks versus bonds versus cash. Eighty or 90 percent of the investment decision is really right there, your

asset allocation. Then when you have picked stocks and bonds, how to best invest——

Chairman SHELBY. You have funds that specialize in bonds.

Mr. GENSLER. That is right.

Chairman SHELBY. You have some in stocks.

Mr. GENSLER. That is right.

Chairman SHELBY. Everything, don't you?

Mr. GLASSMAN. Yes, just in answer to your question, Mr. Chairman, it is kind of interesting that Mr. Berry and Mr. Gensler should really focus on some very simple ideas, very simple metrics. I really think those are the key. I completely agree with them. A lot of the discussion today has been about arcana, which, quite frankly, most investors just—I mean, they are either not interested in it or they don't have the time. They are doing other stuff with their time.

What do they need to know? They need to know the past performance of the fund, the objective of the fund, the volatility, which is basically the way we define risk, and the——

Chairman SHELBY. The integrity of the fund.

Mr. GLASSMAN. Excuse me?

Chairman SHELBY. The integrity of the people running the fund.

Mr. GLASSMAN. Absolutely. That is a very difficult thing to find out, and that is one of the reasons that people go to third parties to make their decisions about funds. How are they going to judge the integrity of an individual fund manager? That is hard. The brand is important; a brand like T. Rowe Price or like Fidelity is important—and absolutely expenses. People need to know more about expenses. But they have tons of information as it stands right now about all these things, and I urge them to go to places like Morningstar to get probably much more than they want to know—maybe not more than they need—well, yes, I would also say probably more than they need to know, most of them.

Chairman SHELBY. They should get involved and know probably more than just glancing at something, because if we have mutual funds totally with trillions of dollars in it, this is big. It is big for the capital markets. It is big for the investor.

Mr. GLASSMAN. Yes. But I want to reemphasize something that Gary just said. Mutual funds are a way to meet specific investment aims. Asset allocation is much more important. That is how you divide up your assets among stocks, bonds, and cash—much more important than which individual mutual fund you pick. And so, we don't really want to lose sight of the forest for the trees here.

Chairman SHELBY. Mr. Phillips.

Mr. PHILLIPS. I think we should be careful about these arguments and say let's dumb down the information, let's keep it very simple because investors are overwhelmed, and realize that there are also a lot of forces in the market that work to help investors. Financial advisers, the majority of investors are going through an adviser, a professional. When a State treasurer chooses funds for a 529 plan, the stuff that we may say is arcane information that the investor doesn't want to see is very important to these people that have a fiduciary role to the investor. Academics study the industry, and the more disclosure they have, the more they can

contribute to the aggregate body of knowledge that we have about mutual funds.

So while this data may not be that important that every individual is going to read it, it will make an impact on the marketplace. Perhaps you don't put these things front and center, but more disclosure and more information about costs and whether management's interests are aligned with investors will make a difference to companies choosing funds for a 401(k) plan and other professionals that are helping the investor with their choices.

Chairman SHELBY. Gentlemen, thank you for your patience. Thank you for the information you have brought to the Committee, and we will continue our hearings in a thorough way and try to balance what is right here and without rushing to judgment.

Thank you.

[Whereupon, at 12:22 p.m., the hearing was adjourned.]

[Prepared statements and additional material supplied for the record follow:]

PREPARED STATEMENT OF SENATOR MICHAEL B. ENZI

Thank you, Chairman Shelby, for the third in a series of oversight hearings on the mutual fund industry. It has been nearly 3 months since our last hearings on this issue were held and since that time many significant events have taken place.

Back in November, I stated that virtually every day since the revelation of market timing and late trading abuses, the mutual fund industry appeared on the front pages of newspapers and was featured in television news segments and radio interviews. That situation does not appear to have changed. Just over a week ago, news surfaced of a mutual fund's employees permitting market timing of a mutual fund set up for young investors.

Unfortunately, the bad actors in the mutual fund industry, who put their own interests ahead of their shareholders' and in the case I just cited ahead of children, have put a cloud over the entire industry. I have no doubt that the individuals in charge of preventing abuses to the system will be brought to justice. Their actions clearly violated the current regulatory scheme, and the SEC and State regulators already have commenced enforcement actions to rid the industry of them.

It also is clear that the SEC has been extremely busy since our last set of hearings. The Commission has been putting together a series of rule proposals to clarify existing law and to ensure that the grey areas of a mutual funds' activities are clearly marked as black and white. Some of the proposals, including one on mutual fund compliance programs, have already been adopted. While I support many of the SEC's actions in this area, it is clear that there are many important areas that need to be fully and carefully examined before final action takes place.

For example, the SEC proposed a "hard 4 o'clock" close for orders of mutual fund shares to reach the mutual funds. As I am a Member of the Committee on Health, Education, Labor, and Pensions, I have heard from many pension and benefit plan administrators, especially from the mountain and the western States that a hard 4 o'clock close would place employees with pensions and with 401(k) plans at a disadvantage with investors who place orders for mutual fund shares directly with mutual funds.

Also, there are issues that appear ripe for a quick regulatory or legislative fix. However, upon closer examination, these issues are far more complex and intricate than they first appear. For example, certain industry members would institute a complete ban on so-called "soft dollars" which may be a misnomer in itself. Unfortunately, other industry members state that a complete ban would place independent research firms at a competitive disadvantage. These are the same research firms that were described as essential for investor confidence in last year's $1.4 billion SEC and State global settlement with Wall Street firms. We need to fully understand why these independent research firms would be placed at a disadvantage and what can be done so that they are not disproportionately affected by any proposed changes to the way the industry operates.

Before us today, we have a diverse panel of mutual fund experts that will help us to understand better the operations and corporate governance policies of mutual funds from the perspective of investors. Their testimony is essential for us to have a clearer comprehension of the intricacies of the operations of the mutual fund industry, an industry structured unlike any other financial or corporate industry. We need their expertise to help us discern the true effects of proposed reforms that have been raised to date.

For example, I have serious questions about the recent SEC proposal to require an independent chairman for a mutual fund even if the mutual fund's board is comprised of a super-majority of independent directors. Another proposal that the Commission is considering this morning would require a mandatory redemption fee for investors that trade within a short period of time. I am unclear as to whether this proposal will completely stop market timing abuses and I am concerned that the proposal may have unintended consequences for some individual investors. The witnesses' testimony is crucial for our understanding of issues like these.

If legislation is necessary, I would like to see Congress thoroughly evaluate the problem to find the right solution. We should not rush to pass legislation as we may do undue harm to the industry. I applaud the Chairman for taking a similar approach that we used in the Sarbanes-Oxley Act.

Typically, for every action, Congress has a tendency to overreact. In this situation, we need to thoroughly review the problems to find the appropriate solution. In addition, we still have a responsibility to make sure that whatever action is taken does not have a negative cascading effect on small entities and small investors.

Several of our witnesses in their written testimony have cited a greater need for investor education and financial literacy. I wish to note that the Financial Literacy and Education Commission created by the Fair and Accurate Credit Transaction Act

(FACT) of 2003, held its first meeting last month to coordinate the Federal Government's financial literacy and education efforts. Financial literacy has been a very important issue for Senator Sarbanes, our colleagues on the Committee, and I. I appreciate your efforts to have it included in the FACT Act.

Thank you, Mr. Chairman, for holding this hearing. I appreciate the effort that you are taking to carefully analyze the problems with the mutual fund industry. I look forward to working with you on future Committee hearings highlighting this very important matter.

PREPARED STATEMENT OF TIM BERRY

INDIANA STATE TREASURER AND
PRESIDENT, NATIONAL ASSOCIATION OF STATE TREASURERS

FEBRUARY 25, 2004

Introduction

Mr. Chairman, thank you for the opportunity to appear before this distinguished Committee. My name is Tim Berry and I am the Treasurer of the State of Indiana. I am honored this year to also serve as the President of the National Association of State Treasurers. We are very pleased to offer our comments relative to current mutual fund practices and their impact upon investors, including the States as investors. We are also pleased to provide you information on efforts to expand investor education, and the role such efforts play in building investor confidence in the financial markets.

The National Association of State Treasurers, or NAST, is a bipartisan membership organization composed of all State treasurers, or State finance officials, from the United States, its commonwealths, territories, and the District of Columbia. As the elected chief financial officers of the States, the State treasurers directly oversee more than $1.5 trillion dollars in State funds. The treasurers are important daily participants in the domestic securities markets, investing State funds in U.S. corporations and small businesses. They have a direct stake in the health of the Nation's economy and diligently share their expertise in fiscal and investment matters with other Government officials and the general public. Based on this role, the State treasurers are in the forefront of addressing concerns about corporate business practices and governance, leading efforts to ensure investor confidence in the stock markets and to increase shareholder value for the citizens of their States.

A great majority of State funds are invested in the domestic equity markets. Earnings from investments are an important source of revenue for State governments. These earnings are used to fund vital public services, to cover public employee retirement obligations, to help families save for college, and to fund beneficial economic development programs, among other uses. In contemporary financial markets, maximizing this source of revenue is a complex and time-consuming undertaking. To make the best use of investible public funds, investors like the State treasurers strive to earn the best returns possible without sacrificing the safety of their funds or subjecting their portfolios to undue risks. State treasurers and other public investors must achieve this goal within the constraints of applicable State and Federal laws, keeping in the forefront the overriding principles of safety, liquidity, and yield.

The nature of State investments has made the State treasurers keenly aware of issues surrounding the mutual fund industry and its impact on investor confidence in the capital markets. We believe that accurate and reliable financial reporting lies at the heart of our financial market system and that investor confidence in such information is fundamental to the health of our markets. We further believe that expanding and strengthening the disclosure requirements of mutual fund companies will address concerns about investor confidence and enhance efforts to raise the level of understanding of the complexities and risks of mutual fund investing.

What is at Stake?

The recent allegations of fraud in the mutual fund industry have fundamentally altered Americans' perceptions of these important investment vehicles. These allegations do not involve isolated instances of individual wrongdoing by low-level employees—the proverbially "few bad apples," but rather appear to involve a large number of mutual fund complexes, and wrongdoing by a significant number of employees, including, in some cases, executives at the highest levels of management.

Revelations regarding significant problems in mutual fund compliance have made regulatory reform a critical issue. The alleged frauds in these cases were open and

notorious and violated express legal requirements. Fund stewards were on notice and failed to take action. Recently, the U.S. Securities and Exchange Commission surveyed most of the largest mutual fund complexes in the country and all of the Nation's registered prime brokers. Preliminary findings reveal the apparent prevalence with which mutual fund companies and brokerage firms had arrangements that allowed favored customers, including themselves, to exercise after-hours trading privileges and market timing options—as well as the ability to participate in other abusive practices.

Investors have placed their trust in mutual funds with the understanding that they would be treated fairly—that fund managers would do their duty as fiduciaries. Unfortunately, there have been instances where the mutual fund industry has failed to live up to its fiduciary duty. The common theme running through all of the mutual fund issues that have been exposed in recent months is that certain participants in the mutual fund industry are putting their own interest ahead of mutual fund investors.

These violations of the fiduciary duty owed to investors have caused real harm—particularly in confidence and in lost investment value. These frauds reflect a systemic compliance failure in the sense that the current structure of fund oversight is not resulting in fund shareholders receiving the most fundamental and obvious forms of protection from actual and potential abuses. If shareholders are not being protected from the most obvious frauds, they may not have any confidence that they are being protected from frauds that we have yet to or may never discover.

The Vital Role of State Treasurers

The State treasurers have a direct stake in issues raised by mutual fund trading and sales practices. Twenty-five States utilize money market mutual funds to invest a portion of their general fund investments. Thirty-eight States use mutual fund companies as intermediaries for general fund investments. Many State treasurers also directly oversee or sit on the boards of State and local government pension plans, including supplemental pensions, 401(k) and deferred compensation plans, many of which are based on mutual fund investments. Most significantly, the State treasurers are directly involved in the oversight and management of Section 529 college savings plans, the bulk of which are based on an investment model linked to the mutual fund market.[1] Additionally, numerous mutual fund firms manage institutional portfolios for State and local government pension systems and other investment programs, but these operations are generally separate from the mutual fund's retail business. Mutual fund investments and mutual fund companies are a critical component of the treasurers' investment functions.

As fiduciaries of public investment funds, the State treasurers, their investment oversight boards, and their money managers maintain great responsibilities which bear directly on mutual fund company issues. First, as *fiduciaries,* they have a duty to act prudently and in the best interests of their plan participants and beneficiaries. Second, as investors, they have an opportunity and duty to speak out on the strategy, direction, and governance of the mutual funds in which they and their constituents invest. This is the essence of responsible investment management. State and local governments are among the Nation's most important institutional investors. Both singly and collectively, Government fund investments are frequently the most important shareholders a mutual fund has. Consequently, they are in a unique position to influence corporate policies and financial markets.

Federal laws such as ERISA generally do not apply to State and local pension funds, which are governed by State and local regulatory structures that vary from jurisdiction to jurisdiction. In every jurisdiction, however, those who control State and local investment funds—State treasurers, pension boards and trustees, etc.—are considered fiduciaries. As fiduciaries, they are duty-bound to act in good faith and for the exclusive benefit of plan participants and beneficiaries. They must discharge their duties with the care, skill, and diligence that a prudent investor would exercise on his or her own behalf under like circumstances. To meet this high standard,

[1] The enactment of Economic Growth and Tax Relief Reconciliation Act in 2001 has enhanced the attractiveness of Section 529 plans by allowing greater contributions and flexibility in the plans. The 2001 Act allows tax-free distributions from Section 529 savings plans for qualified higher-education expenses. Previously, withdrawals from these accounts were generally taxed at the rate of the beneficiary—usually a child or grandchild. In another change, contributors now will be able to move their 529 plan investments from one State's plan to another once a year without having to change beneficiaries. As a result, assets in Section 529 savings plans have more than quadrupled since 2001, increasing from $8.5 billion at year-end 2001 to $45.7 billion by December 31, 2003. The number of accounts rose to over 6 million, and the average account size was approximately $7,600.

they must demonstrate that the investment practices and policies they adopt on behalf of plan participants and beneficiaries are fundamentally sound.

As fiduciaries, State treasurers must factor allegations of improper mutual fund practices into the fiduciary's determination of the continuing appropriateness of a fund. They must be attentive to activities that materially affect the plan's investment in the mutual fund or expose the plan to additional risk. They must have more active communication with mutual fund management in order to meet their obligations under State law.

As competent and effective fiduciaries, individual State treasurers are demanding numerous changes to the manner in which corporations and mutual funds operate. These important activities have long been recognized as a fundamental function of our association, which last year established a standing committee on corporate governance. Currently chaired by Connecticut Treasurer Denise Nappier and Nevada Treasurer Brian Krolicki, the Corporate Governance Committee has taken a leading role in responding to issues raised by corporate behavior, including work on the proxy access issue, reforms to corporate board structure, composition and functions, and oversight of the stock exchanges. We have taken a number of strong positions on these matters and would be pleased to share them with the Committee.

In a continuation of these efforts, North Carolina Treasurer Richard Moore, working with our Corporate Governance Committee, has implemented a series of "mutual fund investor protection principles" designed to provide greater transparency in mutual fund practices. The principles aim to stop late day trading by requiring the fund to hold all trades for 12 months. They require the fund to report how the managers are compensated and require at least two-thirds of the mutual fund board to be independent directors.

These principles illustrate how the treasurers are acting in good faith on behalf of the citizens of their States. They are discharging their duties with care, skill, and due diligence. They are adopting fundamentally sound investment policies and implementing them within their States. They are attentive to fund activities that are affecting the health of their State's investments. And finally, they are active in their communication with mutual fund management, working to find equitable solutions to recent industry abuses. These actions have been taken with a fundamental goal in mind: To restore investor confidence, mutual fund companies need to provide timely and accurate information about costs and fees, performance and potential risks. The mutual fund companies should be required to provide investors access to timely and understandable information.

What Should Investors Do?

Investors must actively research and monitor their fund investments to ensure that fund managers have their best interests in mind. At a minimum, investors should look to see that the mutual fund charges reasonable annual expenses; and that the fund management provides open and honest communication with investors.

The fees charged for participation in a mutual fund are a key issue for investors. These fees can be substantial and may erode investment returns in mutual funds. Generally, investors do not pay enough attention to mutual fund expenses. Some funds charge investors upfront or back-end "loads," or commissions, and all funds charge investors management fees, under the term "expense ratio." Investors should be aware that even small fees may detract from growth in investments. In fact, fees mount over time because investors' total assets mount as well.

These recommendations, of course, are predicated on investors having adequate access to timely and intelligible information on mutual fund fees and expenses. Equally important, particularly for the long-term health of investors, and by extension to the whole economy, these investors need a strong education on how to approach and manage mutual fund investments. Thus, in considering regulatory reform, the Committee should also address the scope and adequacy of financial literacy training in the United States.

Policy Recommendation

In recent months, the Securities and Exchange Commission has taken a number of steps to address issues raised by State and Federal investigations into mutual fund sales and trading practices. For example, to address late trading issues, the Commission adopted a new rule to require that an order to purchase or to redeem mutual fund shares be received by the mutual fund by the time that the fund establishes for calculating its net asset value in order to receive that day's price. We believe this rule would effectively eliminate the potential for late trading through intermediaries that sell fund shares.

The Commission also recently proposed an amendment to Rule 12b–1 under the Investment Company Act of 1940 that would prohibit mutual funds from directing

commissions from their portfolio brokerage transactions to broker-dealers to compensate them for distributing fund shares. This would eliminate a large potential conflict of interest, aligning fund companies more directly with the interests of their shareholders.

The Commission also recently adopted a compliance rule that will require these funds and advisers to have compliance policies and procedures, to annually review them and to designate a chief compliance officer who, for funds, must report to the board of directors. The designated compliance officers and written policies and procedures will have several benefits, including having a designated person charged with fund compliance who must answer to, and be accountable to, the fund's board of directors, thereby enhancing compliance oversight by directors, as well as allowing the SEC's examination staff to review the reports made to the board.

In addition, the Commission proposed enhanced disclosure requirements. These enhancements would require funds to disclose market timing policies and procedures, practices regarding "fair valuation" of their portfolio securities and policies and procedures with respect to the disclosure of their portfolio holdings. This type of disclosure should shed light on market timing and selective disclosure of portfolio holdings so that investors could better understand the fund's policies and how funds manage the risks in these areas. Mutual fund boards of directors play an important role in protecting fund investors. They have overall responsibility for the fund, oversee the activities of the fund adviser, and negotiate the terms of the advisory contract, including the amount of the advisory fees and other fund expenses. In order to improve such governance, the Commission recently proposed amendments to its rules to enhance fund boards' independence and effectiveness and to improve their ability to protect the interests of the funds and fund shareholders they serve. First, independent directors would be required to constitute at least 75 percent of the fund's board. Second, the board would be required to appoint a chairman who is an independent director. Third, the board would be required to assess its own effectiveness at least once a year. Its assessment would have to include consideration of the board's committee structure and the number of funds on whose boards the directors serve. Fourth, independent directors would be required to meet in separate sessions at least once a quarter. Finally, the fund would be required to authorize the independent directors to hire their own staff.

We commend the Commission for its efforts in this area. The new rules governing board composition and functions, as well as governing trading practices and expense disclosures, will go a long way toward rectifying many of the abuses identified in the recent investigations of the mutual fund industry.

The implementation of these new rules confirm our opinion that the mutual fund industry is neither inherently corrupt nor in need of a major structural overhaul. While these rules properly clarified and strengthened, it is not necessary to undertake wholesale reform of the regulation of this industry. The vast majority of people in the fund management industry are honest and hard working. Collectively, they provide a valuable service to the American public. Moreover, the U.S. fund industry has a good long-term record of serving investors. This record reflects the strengths of the industry's structure and the emphasis placed on disclosure by its overseers and regulators. To the extent that the industry has lost its way in recent years, we believe that it is a function of its participants placing profit over the needs of mutual fund investors. The profitability of the fund company or its employees must never take precedence over the interests of fund shareholders.

However, we remain concerned in particular about a practice that does great damage to investor confidence in the fairness and equity of mutual fund investments. Specifically, what are prospective mutual fund investors being told about revenue sharing arrangements and other incentives provided by mutual fund companies to brokers selling their funds? Do customers understand that their broker is being paid to sell a particular fund? And when these payments are being made from fund assets, do customers understand that their own investment dollars are being used to foot the bill for the mutual funds' premium "shelf space" at the selling broker's office? Such fees may increase costs to investors, as well as create conflicts of interest between investors and the financial professionals with whom they deal.

Congress should act promptly to eliminate this gap in mutual fund fee disclosure. Current SEC rules and positions provide investors with a misleading picture of the incentives of brokers from whom they buy fund shares. If an investor buys shares of a particular company, his broker must send a confirm that shows how much the broker was paid in connection with the transaction. In contrast, if an investor buys shares in a mutual fund, the confirm is not required to provide this information. The Commission is considering possible solutions to this problem. But we believe this issue is so critical to restoring confidence in mutual funds, that Congress should require that all compensation received by brokers in connection with sales of fund

shares be disclosed on fund confirmations, as well as any information necessary to direct investors' attention to incentives that a broker may have to prefer the sale of one fund over another. With America's investors experiencing a crisis in confidence in the mutual funds, fee disclosure reform is more important than ever.

Financial Literacy Programs

In order to succeed in our dynamic American economy, our citizens must be equipped with the skills, knowledge, and experience necessary to manage their personal finances and retirement needs. All members of our society should have the financial knowledge necessary to make informed financial decisions. Despite the critical importance of financial literacy, many citizens lack the basic skills related to the management of personal financial affairs.

The recent allegations of fraud in the mutual fund industry underscore the tremendous need for financial education in the United States. Improved financial education will help mutual fund investors better understand the costs associated with this form of investment, as well as the risks and rewards of mutual fund investing. A better educated class of investors would understand the industry, which would increase overall confidence in the capital markets.

State treasurers have long recognized the need for improved financial education for all of our citizens. For many years, treasurers have taken a very active role in promoting financial literacy to the residents of their State. State treasurers strive to provide and promote financial education for the benefit of the citizens of the States, to improve their quality of life. State treasurers draw on their substantial expertise in the financial management of both personal and public funds to provide opportunities to educate the citizens of the States on savings, from birth to retirement. Members emphasize there is a critical need for personal savings to the citizens of the States. Through the legislative processes, State treasurers support public policy positions that promote savings, and seek changes of current policies which hinder and penalize savings.

The financial literacy programs range across a variety of target demographic groups, from school age children, to women, to public officials. For example, State treasurers have developed an innovative personal finance workshop targeting women interested in learning how they can take control of their financial situations. Since that first Women and Money Conference, more than 15 treasurers have implemented this program in their States. The treasurers in Delaware, Maine, Massachusetts, Ohio, and many other States have developed strategic partnerships with local, regional, and national organizations and they continue to provide Women and Money Conferences for residents of their States.

Alabama Treasurer Kay Ivey, who has worked on financial education matters for 30 years, works closely with local boys and girls clubs to teach financial basics to the young people in her State. In another example, Delaware Treasurer Jack Markell has developed an innovative program called the Delaware Money School designed to bring community-based financial education to participants in a pressure free learning environment. Topics covered in the Money School include basic money management, investing, and retirement planning. Specialized classes are also offered at the request of churches, senior citizen centers, or community groups.

In the Delaware Money School, a coalition of financial professionals—from the financial service industry, nonprofit organizations, and government—volunteer to teach the classes. The Money School is a collaborative undertaking with various community and public organizations, it can also be structured to fit the specific needs of a group of people or provide educational opportunities as they arise.

Many of us take the lead in providing education programs for State and municipal employees charged with managing public finances. These workshops present participants with tools to deal with the fiscal and ethical issues they face when investing public resources. In some States, continuing education is mandated for public fund managers, and the treasurers' programs satisfy this requirement. In other States, the treasurers initiate the workshops on their own. In California and Ohio, where the programs are mandated, more than a dozen workshops on topics, ranging from investment management to innovative financing techniques, are held each year. In Illinois and Indiana, where the programs are not required by law, the treasurers hold annual conferences for local public finance officials.

In addition to the programs administered by the States, the National Association of State Treasurers has taken an active role in providing educational opportunities to members and other public officials responsible for the management of public funds. For 8 years, NAST has sponsored the National Institute for Public Finance, a comprehensive curriculum designed to enhance participants' understanding of public financial management and increase their abilities to make independent financial decisions. We also recently established the NAST Foundation, a not-for-profit

organization, to promote and improve the educational initiatives of the organization and individual State treasurers.

The common theme among these programs is the vital need to provide all citizens, and the public officials who serve them, the tools and information to understand and negotiate our complex financial markets. The issues raised by the recent developments in the mutual fund industry amplify this need. Financially literate investors, supplied with clear and understandable information, are better able to make informed investment decisions, which is critical to their and the Nation's financial health and well-being.

Conclusion

Collectively, legislators, regulators, and the industry can rebuild and preserve the public's trust in mutual funds by implementing stronger disclosure requirements in order to better align fund management company interests with those of fund shareholders. This will give current and prospective investors access to the type of information to enable them to make fully informed decisions about their investments.

By bringing more visibility to the corporate structure of funds and by enhancing the availability and usefulness of financial information disclosed by the firms, this Committee can demonstrate to American investors that mutual funds will continue to operate as the cleanest, brightest investment method for all Americans. The industry does not need a wholly new set of operational rules or new oversight groups, it simply needs to be held accountable to both the letter and the spirit of the rules that have guided it well for decades. We believe the simple improvements suggested here can help keep the industry focused on its ultimate mission—helping investors meet their goals and secure a safer future for their families.

PREPARED STATEMENT OF JAMES S. RIEPE

VICE CHAIRMAN, T. ROWE PRICE GROUP, INC.

FEBRUARY 25, 2004

Introduction

My name is James S. Riepe. I am Vice Chairman of T. Rowe Price Group, Inc., a Baltimore-based firm that, through its affiliates, provides investment management services to the T. Rowe Price family of no-load mutual funds and to individual and institutional clients. In addition, I am Chief Executive Officer of each of the Price Funds and the Chairperson of all the Price Fund Boards. T. Rowe Price acts as sponsor, investment adviser and distributor of 108 mutual funds and variable annuity portfolios which, as of the end of 2003, exceeded $120 billion in assets. In total, T. Rowe Price manages approximately $190 billion in assets.

I appreciate the opportunity to appear before the Committee today to discuss the ongoing efforts of my firm, and the mutual fund industry as a whole, to respond to abusive mutual fund trading practices by taking concrete and far-reaching actions to protect investors' interests and prevent future abuses. I also note that my comments come from the perspective of having been engaged in the mutual fund business for the last thirty-five years.

Executive Summary

T. Rowe Price Group operates its mutual fund business in accordance with the fundamental principle that the interests of our fund shareholders are paramount. Consequently, we have been deeply dismayed by the recent revelations of abusive mutual fund trading practices.

We support appropriate action by Government authorities to redress these abuses, and we commend the SEC for its swift and comprehensive regulatory response. As we have urged for a number of years, it is critically important that the SEC receive increased funding to develop appropriate regulatory initiatives and to carry out its mutual fund oversight and inspection duties.

We also recognize that the challenge of restoring and maintaining investor trust falls not on the regulators but on those of us in the business of managing and distributing funds. T. Rowe Price takes this responsibility very seriously.

T. Rowe Price has policies, procedures, and practices in place that seek to protect Price Fund shareholders against late trading, abusive short-term trading of mutual fund shares, and selective disclosure of fund portfolio holdings. In response to the recent investigations and enforcement proceedings, we have conducted thorough reviews of our policies, procedures, and practices in these areas, which has allowed us to confirm their continuing effectiveness and to implement or consider certain enhancements.

We have, as always, kept the Price Fund Boards fully informed of our actions and they have played an active oversight role. We have also sought to educate fund investors—through communications on our website, in our newsletter, and in fund shareholder reports—about the alleged improprieties and how we protect Price Fund shareholders from these types of abuses.

The efforts of individual firms such as T. Rowe Price to address the concerns raised by the scandal have been significant and are being supplemented by a series of regulatory initiatives.

Late Trading

To protect against the possibility of late trading, the SEC has proposed rule amendments that would mandate that all purchase and redemption orders be received by a fund, its transfer agent, or a registered clearing agency before the time the fund prices its shares (e.g., 4 p.m. Eastern time). T. Rowe Price supports the SEC's proposed approach, until such time as an electronic trade monitoring process is available that would allow other entities to receive fund orders on behalf of a fund for pricing purposes.

Excessive Short-Term Trading

T. Rowe Price also supports the various regulatory measures that the SEC has proposed and/or adopted to address abusive market timing activities, including: (1) requiring funds to have more formalized short-term trading policies and procedures and to explicitly disclose those policies and procedures, (2) emphasizing the obligation funds have to fair value their securities under appropriate circumstances, and (3) providing a more effective mechanism for board oversight of market timing policies and procedures.

With respect to personal trading activities of senior fund personnel, the SEC has recently proposed new code of ethics requirements for registered investment advisers, which T. Rowe Price supports.

Funds and their shareholders also would benefit if funds had additional "tools" to combat harmful market timing activity, such as a minimum 2 percent redemption fee on fund shares redeemed within a minimum of 5 days of their purchase. The SEC is expected to propose requiring such minimums for certain categories of funds and we support this approach, but note the need to provide a sufficient time period for implementation.

Fund Governance

The recent disturbing revelations do not evidence a failure of the fund governance system but they do indicate that fund directors would benefit from additional tools to assist them in serving effectively in their oversight role. The mutual fund compliance program rule recently adopted by the SEC will have a significant and far-reaching impact on improving the compliance environment and enable fund directors to more readily oversee this important activity. Certain proposals to "improve" fund governance are, however, unwarranted, unrelated to the abuses that have been revealed and counterproductive, such as mandating that all fund boards have an independent chair and requiring independent directors to make certifications relating to matters outside the scope of what they could reasonably be expected to know.

Other Initiatives

In addition to internal measures and regulatory changes to protect investors against the abusive mutual fund trading practices that have been the subject of recent investigations and enforcement proceedings, it is appropriate to consider other ways to reinforce the protection and confidence of mutual fund investors. In this vein, the SEC recently proposed, and T. Rowe Price supports, rule amendments to ban the practice of directing fund brokerage transactions to reward broker-dealers who also sell fund shares. In addition, the SEC has embarked on a prudent and timely reevaluation of Rule 12b–1. Finally, the SEC has proposed to require broker-dealers to provide a separate document to mutual fund investors at the point of sale that will help inform them about sales-related fees and payments and alert them to possible conflicts of interest.

T. Rowe Price is committed to protecting our fund shareholders against abusive mutual fund trading activities. We support those Government and industry efforts which are designed to address these issues and other initiatives that will promote investors' interests. We are fortunate that investor confidence in mutual funds generally remains very high, but we must take advantage of the current problems to make improvements that will guard against future breaches of trust and allow our fund shareholders to be confident that their interests come first.

Introduction

My name is James S. Riepe. I am Vice Chairman of T. Rowe Price Group, Inc., a Baltimore-based firm that, through its affiliates, provides investment management services to the T. Rowe Price family of no-load mutual funds and to individual and institutional clients. In addition, I am Chief Executive Officer of each of the Price Funds and the Chairperson of all the Price Fund Boards. T. Rowe Price acts as sponsor, investment adviser, and distributor of 108 mutual funds and variable annuity portfolios which, as of the end of 2003, exceeded $120 billion in assets. In total, T. Rowe Price manages approximately $190 billion in assets.

I appreciate the opportunity to appear before the Committee today to discuss the ongoing efforts of my firm, and the mutual fund industry as a whole, to respond to abusive mutual fund trading practices by taking concrete and far-reaching actions to protect investors' interests and prevent future abuses. I also note that my comments come from the perspective of having been engaged in the mutual fund business for the last 35 years.

T. Rowe Price operates its mutual fund business in accordance with the fundamental principle that the interests of our fund shareholders are paramount. Our fundamental thesis is a simple one: If shareholders prosper then we, as managers, will do likewise; if they do not see value in an investment relationship with us, then our business will do poorly. This principle is applied through formal, documented policies, including a comprehensive Code of Ethics, but, perhaps more importantly, it is also deeply ingrained within the firm's culture. In this context, it is important to understand that one cannot regulate ethical behavior, no matter how extensive the compliance regulations. Ultimately, each of us must create an environment in which the right decisions are made by our employees. Given our culture, and the industry's previously clean record, my colleagues and I were shocked and deeply dismayed by the allegations of late trading and short-term trading in the New York Attorney General's complaint in the Canary case [1] and subsequent allegations of these and other abusive mutual fund trading practices. It is difficult to fathom that persons associated with our industry—fund managers and intermediaries—would knowingly permit the blatantly illegal buying and selling of fund shares after 4 p.m. It is equally troubling that some fund companies allegedly entered into arrangements that authorized short-term market timing in apparent contravention of stated policies in exchange for promises of other benefits to the fund manager. Perhaps most disturbing of all are the revelations that a few fund insiders may have engaged in short-term trading for their own personal benefit, again in contravention of stated policies and potentially at the expense of other fund shareholders.

I commend the Securities and Exchange Commission and the New York Attorney General's office for their investigative efforts and forceful responses to these practices. However, the marketplace impact on the fund companies involved, caused by the disclosure of abuses, has been so severe that it far exceeds the regulatory penalties. This has been a reminder to all of us how important is the implied bond of trust between the investor and the fund manager.

I also commend the SEC for taking swift and sweeping actions on the rulemaking front to address the abusive practices that have been discovered, and to otherwise strengthen mutual fund regulation. I believe the SEC's current far-reaching and aggressive mutual fund regulatory reform agenda is unprecedented.

Of course, in order for the SEC to develop appropriate regulatory initiatives to respond to the trading abuses that have occurred, and to successfully carry out its oversight and inspection duties with respect to mutual funds, it is critically important that the SEC have sufficient resources. Consistent with this, I strongly support the Bush Administration's proposed fiscal year 2005 budget for the SEC, which would provide a significant and necessary increase over the record amount appropriated for the current fiscal year. I note that T. Rowe Price, and the fund industry generally, has argued for increased SEC resources for many years. Funds have historically generated SEC registration fees far in excess of the monies spent on regulating and examining fund companies and related entities.

In addition to the important work of the SEC and other Government authorities in redressing mutual fund abuses, however, the challenge of restoring and maintaining investor trust falls squarely on the shoulders of the industry itself. T. Rowe Price and other mutual fund firms take this responsibility very seriously. In this regard, we are heartened by the fact that investors have not found fault with the fundamental features of funds—convenience, low-cost, diversification, and professional management. This is evident in our thousands of conversations with investors

[1] *State of New York* v. *Canary Capital Partners, LLC, Canary Investment Management, LLC, Canary Capital Partners, Ltd., and Edward J. Stern* (NY S. Ct. filed September 3, 2003) (undocketed complaint).

each day and by the continued flow of tens of billions of dollars into equity, bond, and money market funds.

The remainder of my testimony will: (1) describe what T. Rowe Price has done to protect its fund shareholders' interests against late trading, abusive short-term trading of mutual fund shares, and the practice of selectively disclosing information about fund portfolio holdings to shareholders; and (2) discuss regulatory initiatives in these areas. I will also comment on hedge fund oversight and fund governance issues, as well as certain other current initiatives to reinforce the protection and confidence of mutual fund investors.

Response to Mutual Fund Trading Abuses

Since news of the mutual fund trading abuses first broke, T. Rowe Price, like most other firms, has conducted thorough reviews of our firm's policies, procedures, and practices in the principal areas that have been implicated in the various enforcement proceedings and investigations that have been announced to date. This has allowed us both to confirm the continuing effectiveness of our existing policies, procedures, and practices and to make or consider certain enhancements. Throughout this process, we have kept the Price Fund Boards fully informed of our actions and they have played an active oversight role. Indeed, since the initial revelations, we have held three meetings of the Fund Boards in addition to our regularly scheduled meetings.

In addition to keeping the Fund Boards informed and involved in this process, we believe it is important for investors to understand these improprieties and how we protect Price Fund shareholders from these types of abuses. To this end, we posted a statement on our website last fall emphatically condemning the practices and additional abuses that have been revealed or alleged in these investigations. The statement, which has been continually updated, includes questions and answers about the practices that are under investigation and T. Rowe Price's policies in these areas. We have also updated shareholders on these issues in our newsletter and in the Chairman's letter included in the funds' most recent annual reports to shareholders. Based on what I have seen and heard, it is my impression that most industry participants have developed communications for their investors.

Late Trading

Consistent with existing legal requirements, our mutual fund trading policy, delineated in our fund prospectuses, requires that fund transaction orders received prior to 4 p.m. Eastern time (the time as of which we price our funds) be executed at that day's share price. Orders received after 4 p.m. Eastern time are executed at the following day's price. This policy also applies to shareholders who place their orders through intermediaries such as brokers and retirement plan recordkeepers (i.e., orders received by intermediaries before 4 p.m. will get that day's price). Under current law, these intermediaries are authorized to transmit their customer orders to T. Rowe Price after 4 p.m. for processing at that day's closing price, provided that the intermediary received the orders before that time. Our firm has not and will not enter into any arrangements with investors or intermediaries that authorize post-4 p.m. trading.

In light of recent revelations of "late trading" of mutual fund shares, our Internal Audit Department conducted a review of our established policies, procedures, and practices with respect to the timely receipt of orders to purchase or redeem fund shares and determined that they are sound. This review and the findings were discussed with the Price Fund Boards.

In addition, given the alleged instances of late trading involving transactions conducted through intermediaries, we have taken steps to improve our oversight of intermediaries with whom we conduct business. In particular, we formed an Intermediary Oversight Committee which is charged with:

- Overseeing the relationships with intermediaries.
- Maintaining and enforcing our policies regarding intermediaries.
- Resolving any material issues relating to intermediaries.
- Taking action to terminate intermediaries that have failed to meet our compliance standards.

T. Rowe Price has also required each intermediary with whom we have trading agreements (currently over 200) to sign and return a certification that it is complying with all relevant rules and regulations regarding the handling of orders for the Price Funds on a timely basis.

The SEC, for its part, has proposed to address late trading through rule amendments that would tighten existing regulations to require that all purchase and redemption orders be received by a fund, its transfer agent, or a registered clearing

agency before the time of pricing (e.g., 4 p.m. Eastern time).[2] T. Rowe Price supports the SEC's proposal. Although this approach could have a significant impact on many investors who own fund shares through financial intermediaries, the recent abuses indicate that strong measures are necessary to ensure investor protection. However, it is our expectation that an electronic trade monitoring mechanism will be developed in the near future that will permit trades to be accepted from intermediaries after the closing time. Such a system would create an audit trail that could verify that trade orders were received timely by the intermediaries from customers.

My own view is that, if the SEC expands the list of entities that would be permitted to receive orders on behalf of a fund for pricing purposes under its proposal, it should consider requiring periodic reviews of those entities' internal controls and reports of any material inadequacies (similar to the SAS 70 control review).

Market Timing/Excessive Trading

For many years, T. Rowe Price has taken an active role in minimizing the potential negative impacts from short-term trading by fund investors on our funds and their long-term shareholders. Our firm has not and will not enter into any arrangements with investors or intermediaries that authorize harmful short-term trading in any of our funds.

Frequent trades driven by short-term market timing have the potential to disrupt the management of a fund and raise its transaction costs. For those investors for whom we maintain individual accounts, we review daily trading activity across the complex at a retail, retirement, and institutional level, and we analyze purchases and sales in the funds to determine if the transactions are within the excessive trading guidelines contained in the prospectus. If we determine that a shareholder has violated our guidelines, action is taken to restrict future excessive trading activity. Over the years, this monitoring process has resulted in actions up to and including the suspension of purchase privileges for many individuals and a number of intermediaries.

In addition, to discourage excessive trading, a number of Price Funds impose redemption fees ranging from 0.5 percent to 2.0 percent. The required holding periods vary and can be as long as 2 years.

In the wake of the recent scandals, our Internal Audit Department reviewed our established policies, procedures, and practices concerning excessive trading, including the imposition of redemption fees, and determined that they remain sound. The review and its findings were discussed with the Price Fund Boards. As a result of this review, we have augmented our monitoring methodologies and will be expanding the number of funds subject to redemption fees.

One issue that the recent trading abuses have highlighted is the difficulty of ensuring that fund policies regarding excessive trading, including the imposition of redemption fees, will be appropriately and consistently applied in the case of investors who own fund shares through intermediaries. With respect to intermediaries, the monitoring process is based on aggregate activity for each intermediary and relies on that entity to provide us with specific sub-account information when excessive trading is suspected. As noted above, we have formed an Intermediary Oversight Committee to help ensure, among other things, that intermediaries meet our compliance standards on an ongoing basis. We are also seeking written certification from intermediaries that they are collecting redemption fees in compliance with the funds' policies.

Last fall, SEC Chairman Donaldson outlined various regulatory measures that the SEC staff was considering to address abusive market timing activities.[3] These measures included new rules and form amendments to: (1) require explicit disclosure in fund offering documents of market timing policies and procedures, and (2) require funds to have procedures to comply with representations regarding market timing policies and procedures. Chairman Donaldson also indicated that the SEC would consider measures to reinforce board oversight of market timing policies and procedures. The SEC has recently taken formal action in these areas.[4]

[2] *See* SEC Release No. IC–26288 (December 11, 2003).

[3] SEC Chairman Donaldson Releases Statement Regarding Initiatives to Combat Late Trading and Market Timing of Mutual Funds, SEC Press Release No. 2003–136 (October 9, 2003).

[4] *See* SEC Release No. IC–26287 (December 11, 2003) (proposing amendments to require mutual funds to disclose in their prospectuses both the risks to shareholders of the frequent purchase and redemption of fund shares, and fund policies and procedures with respect to such frequent purchases and redemptions) ("SEC Disclosure Proposals") and SEC Release No. IC–26299 (December 17, 2003) (adopting Rule 38a–1 under the Investment Company Act of 1940 concerning the mutual fund compliance programs) ("SEC Compliance Rule Release"). New Rule 38a–1 requires mutual funds to adopt and implement written policies and procedures reasonably designed to prevent violation of the Federal securities laws, including procedures reasonably de-

T. Rowe Price supports these measures. While our funds and many others already have market timing policies and procedures, requiring funds to adopt formal and detailed policies and procedures in this area and specifically providing for board oversight will ensure that all funds have systems in place to address abusive activity. Such a requirement should also provide a more effective mechanism for boards and regulators to police compliance because more formal policies likely will limit discretion in dealing with short-term traders. Fund shareholders also will benefit from additional prospectus disclosure about a fund's policies on short-term trading by gaining an understanding of how the fund will protect their interests from potentially abusive activity. Requiring that such disclosure be in a fund's prospectus could serve to enhance compliance with the policies. The disclosure also could have a deterrent effect by alerting potential abusers to the fund's policies. Of course, it will be important for any new disclosure requirements to allow funds to achieve an appropriate balance between providing disclosure that would have these beneficial effects and providing overly specific disclosure that inadvertently could serve as a roadmap for potential abusers to circumvent fund policies.

Steps also clearly need to be taken to enable mutual funds to better enforce the restrictions they establish on short-term trading when such trading takes place through omnibus accounts held by intermediaries. One approach would be to require intermediaries to provide information about trading activity in individual accounts to funds upon request (a practice that some intermediaries already have in place). And an additional approach would be to require most types of long-term funds, at a minimum, to impose a 2 percent redemption fee on any redemption of fund shares within 5 days of purchasing them.[5] If funds had a standardized minimum redemption fee along these lines, it should be easier for intermediaries to establish and maintain the requisite systems to enforce payment of those fees.[6] It is encouraging that the SEC appears willing to consider proposing such a requirement.[7] The administrative implications for recordkeepers of such broad-based redemption fees are significant and would have to be examined by the SEC before final approval.

Employee Trading in Fund Shares

In addition to our review of policies, procedures, and practices related to excessive trading by fund shareholders, the firm's Internal Audit Department, its Director of Compliance, and our Ethics Committee (which is chaired by the firm's Chief Legal Counsel and oversees the administration of the firm's Code of Ethics) have reviewed trading by T. Rowe Price personnel in the Price Funds over the last several years. This review did not uncover the existence of any of the abusive trading practices described in recent enforcement actions relating to fund portfolio managers and senior fund executives. The review and its findings were discussed with the Price Fund Boards.

Although our review did not uncover any such abusive trading, we are exploring how to enhance protections against such conduct at T. Rowe Price. The firm has maintained a comprehensive Code of Ethics since 1973. Each employee must annually sign a compliance verification form attesting to his or her compliance with the Code. We are considering the possibility of instituting additional trading controls relating to employee transactions in Price Fund shares that may be similar to the controls in place for many years for employee trading in stocks and bonds. In addition, each year, we conduct Code of Ethics compliance meetings with all employees at the vice president level and above. These meetings will be expanded to include all employees in 2004.

Consistent with the actions we have been considering on a voluntary basis, the SEC recently proposed to require registered investment advisers to adopt codes of ethics that, among other things, set forth conduct expected of advisory personnel

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signed to ensure compliance with disclosed policies regarding market timing. In addition, it requires a fund's chief compliance officer to provide a written report to the fund's board, no less frequently than annually, that addresses, among other things, the operation of the fund's compliance policies and procedures and material compliance matters that occurred since the date of the last report.

[5] Funds should retain the flexibility to impose more stringent redemption fee standards, either in the form of higher redemption fees and/or longer minimum holding periods. Flexibility is important because different types of funds are affected differently by short-term trading. In addition, certain types of funds (e.g., money market funds and funds that are designed specifically for short-term trading) should not be required to assess redemption fees.

[6] At the SEC's request, the NASD formed an Omnibus Account Task Force to consider issues raised by the implementation of mandatory redemption fees in the omnibus account context. *See* NASD, Report of the Omnibus Account Task Force (January 2004), available at *http://www.nasd.com/pdf—text/omnibus—report.pdf.*

[7] *See* SEC News Digest, February 18, 2004. At the meeting, the SEC also will consider any pertinent recommendations from the NASD's Omnibus Account Task Force.

and also require such personnel to report their personal securities transactions, including transactions in any mutual funds managed by the adviser.[8] We support this proposal.

Fair Value Pricing

Short-term trading activity, it appears, is often motivated by a desire to take advantage of fund share prices that are based on closing market prices established some time before a fund's net asset value is set. All mutual funds are required to have pricing procedures in place to establish a share price each business day based on the current market values of their portfolio securities. When market prices for portfolio securities are not readily available or are not reliable, funds must determine the fair value of those securities. In accordance with policies and procedures approved by the Fund Boards, T. Rowe Price has utilized fair value pricing for many years, and on many occasions to address events affecting the value of a fund's portfolio securities.

We recently conducted a detailed review of our valuation policies and procedures, and determined that such policies and procedures are appropriate and are being followed. We have also reviewed our policies and procedures with the Fund Boards.

The SEC has recently taken steps to minimize the possibility that long-term fund shareholders' interests will be harmed by the activities of arbitrageurs seeking to take advantage of stale prices. The SEC issued a statement regarding fair value pricing requirements in its release adopting the mutual fund compliance program rule.[9] In addition to describing the SEC's position on when funds must use fair value pricing, the release states that the compliance program rule requires funds to adopt policies and procedures that require the fund to monitor for circumstances that may necessitate the use of fair value prices; establish criteria for determining when market quotations are no longer reliable for a particular portfolio security; provide a methodology or methodologies by which the fund determines the current fair value of the portfolio security; and regularly review the appropriateness and accuracy of the method used in valuing securities, and make any necessary adjustments.[10] SEC examinations of funds will provide the opportunity to further reinforce and monitor the implementation of applicable requirements in this area.[11]

It is important to note that, while fair valuation can reduce the impact of harmful short-term market timing activity, it cannot by itself completely eliminate such trading. Accordingly, funds (including Price Funds) often employ additional methods to deter market timing activity, such as the redemption fees discussed above.

Dissemination of Portfolio Holdings Information

It appears that several fund managers may have provided information about fund portfolio holdings to certain investors in order to enable them or their clients to trade ahead of the fund, to the potential detriment of fund shareholders. For years, the Price Funds have maintained a formal policy relating to providing information about fund portfolio holdings to clients, shareholders, prospective clients, consultants, and the public. The policy is intended to ensure that all the shareholders are treated in a fair and consistent manner and that the information is not used in inappropriate ways. The policy lists the many pieces of information that may be of interest to shareholders and others (for example, a fund's top 10 holdings) and then indicates when that information will be made available (for example, 7 days after month end). The policy has been very helpful in managing requests for portfolio holdings information. We have reviewed important aspects of the policy with the Price Fund Boards and are considering modest revisions to ensure that it remains

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[8] *See* SEC Release Nos. IA–2209; and IC–26337 (January 20, 2004) ("SEC Code of Ethics Proposal").

[9] *See* SEC Compliance Rule Release, *supra* note 4.

[10] *Id.* at 16–17.

[11] The SEC also has proposed revisions to clarify prospectus disclosure requirements concerning fair value pricing. The proposal is intended to make clear that all funds (other than money market funds) are required to explain briefly in their prospectuses both the circumstances under which they will use fair value pricing and the effects of using fair value pricing. In addition, the proposed revisions are intended to clearly reflect that funds are required to use fair value prices any time that market quotations for their portfolio securities are not readily available (including when they are not reliable). *See* SEC Disclosure Proposals, *supra* note 4. The proposed revisions should serve as a useful complement to the requirements articulated in the SEC Compliance Rule Release and the proposed disclosure of market timing policies and procedures discussed above. As in the case of market timing, however, too much specificity about a fund's fair value pricing policies could prove counterproductive by tipping off arbitrageurs and allowing them to circumvent the policies. Thus, it is equally important that new disclosure requirements concerning fair value policies call for disclosure that will be informative to investors but is not so specific as to invite abusive practices.

responsive to those with a genuine need for the information while also being protective of shareholders' interests.

The SEC has taken several actions to put in place additional, more specific regulatory requirements in this area. First, the SEC Compliance Rule Release states that a fund's compliance policies and procedures under the rule should address potential misuses of nonpublic information, including the disclosure to third parties of material information about the fund's portfolio.[12] Second, the SEC has proposed to require funds to disclose their policies and procedures with respect to the disclosure of portfolio securities, and any ongoing arrangements to make available information about their portfolio securities.[13] Third, as indicated above, the SEC has proposed to require investment advisers to adopt codes of ethics that, among other things, set forth standards of conduct expected of advisory personnel and safeguard material nonpublic information about client transactions.[14]

Similar to market timing, requiring funds to adopt formal policies should ensure that they have a system to prevent disclosure that is not in the best interests of shareholders and to police compliance. Board oversight and public disclosure will further enhance compliance with the policies. At the same time, the approach proposed by the SEC appropriately would preserve some flexibility in how funds release information. T. Rowe Price supports the SEC's initiatives.

Hedge Fund Oversight

The action brought by the New York Attorney General against Canary Capital also underscores the need for some SEC oversight of hedge fund advisers. Last fall, the SEC issued a Staff Report on hedge funds[15] that included a recommendation to require hedge fund advisers to register under the Investment Advisers Act of 1940. As the Staff Report indicates, by requiring hedge fund advisers to register, the SEC would be able to observe the trading activities of the funds managed by such advisers and be in a better position to detect improper or illegal trading practices.[16] T. Rowe Price supports the SEC recommendation to require those advisers to hedge funds that are not otherwise already registered to register under the Investment Advisers Act.

Fund Governance

The recent disturbing revelations about mutual fund abuses have caused some to question the effectiveness of the fund governance system. However, blaming directors, especially independent directors, for failing to uncover the wrongdoing that has occurred is unfair. Independent directors cannot—and should not—be responsible for the day-to-day management of a fund's, adviser's, distributor's, or recordkeeper's activities. Indeed, in several cases, the problematic conduct took place at unrelated entities.

The recent incidents do indicate that directors would benefit from additional tools to assist them in serving effectively in their oversight role. The SEC's mutual fund compliance program rule, discussed above, should serve as a useful vehicle for this purpose by requiring funds to have compliance policies and procedures reasonably designed to prevent violation of the Federal securities laws and by improving the flow of information about the policies and procedures, as well as significant compliance issues, to the directors. In addition, the SEC has proposed several new fund governance requirements that should help enhance the independence and effectiveness of fund boards.[17] However, certain other proposals to "improve" fund govern-

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[12] *See* SEC Compliance Rule Release, *supra* note 4, at 19. The rule requires that the fund's board approve the policies and procedures. In addition, it provides for regular reporting to the board on the effectiveness of the policies and procedures, any changes thereto, and material compliance matters.

[13] *See* SEC Disclosure Proposals, *supra* note 4.

[14] *See* SEC Code of Ethics Proposal, *supra* note 8.

[15] Staff Report to the U.S. Securities and Exchange Commission, *Implications of the Growth of Hedge Funds* (September 2003) ("Staff Report").

[16] *Id.* at 92–95.

[17] The SEC has proposed to require, among other things: That the board perform an annual self-assessment that would include consideration of the board's committee structure and the number of boards on which the directors sit; that the independent directors meet in separate sessions at least once each quarter; and that funds authorize the independent directors to hire their own staff. *See* SEC Release No. IC–26323 (January 15, 2004) ("SEC Fund Governance Proposals"). T. Rowe Price supports these measures, although our fund directors view themselves as already having authority to hire staff if appropriate. In addition, the SEC has proposed to require that independent directors constitute at least 75 percent of each fund board. While we support requiring a supermajority of independent directors, we question whether the marginal benefits, if any, of a 75 percent requirement would outweigh the disruption involved in imposing

Continued

ance in the wake of the recent scandals are unwarranted, counterproductive, and would not improve the substantive oversight of the board.

One such proposal would require mutual fund boards to have an independent chair. While some fund boards may choose to have an independent chair—as a number now have—not all fund boards may find that this structure works well for them.[18] It seems counterintuitive to *mandate* such a requirement, instead of allowing the directors to determine in their best judgment who is the most appropriate person to serve as the board's chair. This reasoning is reinforced by the fact that the SEC (and applicable law) already relies heavily on the independent directors' judgment with respect to protecting the interests of shareholders. Furthermore, the independent directors already constitute at least a majority (and in most cases a supermajority) of a mutual fund's board, and therefore have full power to appoint an independent chair if they wish to do so. In the case of T. Rowe Price, fund directors some years ago appointed a "lead independent director" and believe that approach has served them and the funds' shareholders well. With a supermajority of independents, they believe they are able to take any action needed.[19]

Also, it is far from clear why mutual fund boards, alone among all corporate boards, should be deprived of the discretion to choose their chairperson. Existing regulatory requirements and industry practices, as well as the other new fund governance requirements recently proposed by the SEC, make a requirement to have an independent chair unnecessary.[20] Finally, it bears noting that some of the funds involved in the recent scandals have independent board chairmen. Thus, it would be folly to suggest that requiring all fund boards to have independent chairs is in any way an answer to the current problems.

Another misguided "solution" to the abusive trading practices that we have seen would require independent directors, or an independent chair, to make a series of certifications, many of which relate to matters that are outside the scope of what an independent director—who serves in an oversight capacity—could reasonably be expected to know (e.g., that the fund "is in compliance" with certain policies and procedures, such as fund share pricing policies and procedures).[21] Not only would this potentially expose those certifying directors to increased liability, but also it would not serve the best interests of fund shareholders. Independent directors (or the independent chair) would be faced with the Hobson's choice of either: (1) seeking to secure and being forced to rely on a series of sub-certifications from those directly involved in the various matters to be certified (because the directors themselves would not be in a position to have personal knowledge of what they are certifying), or (2) immersing themselves in the day-to-day intricacies of fund operations, thereby inappropriately transforming their role from "oversight" to "management." Both of these results would place the independent directors in an awkward and/or inappropriate position and neither would improve investor protection. On the contrary, an independent director certification requirement could give investors a false sense of

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that standard rather than codifying the two-thirds supermajority that most fund boards have. The SEC also has proposed to require fund boards to appoint an independent chair which, as discussed in more detail below, T. Rowe Price believes should not be mandated for all fund boards. We recently sent a letter to the SEC staff setting forth T. Rowe Price's views on these important matters. *See* Letter from Henry H. Hopkins, Chief Legal Counsel, T. Rowe Price Associates, Inc., to Mr. Paul F. Roye, Director, Division of Investment Management, Securities and Exchange Commission, dated January 13, 2004.

[18] For example, some funds have found that having an interested director serve as board chair is beneficial in that it promotes administrative efficiencies.

[19] For example, several years ago the T. Rowe Price funds' audit committee expressed a desire, for reason of the appearance of a conflict, to have different independent accountants than those who served the funds' adviser. The full boards supported this recommendation and, as a result, the adviser replaced its auditors.

[20] For example, the Investment Company Act requires a separate vote of the independent directors on virtually all important decisions, such as approval of the fund's investment advisory and underwriting agreements, and the use of fund assets to support the distribution of fund shares under a Rule 12b–1 plan. Existing practices in the fund industry—such as a supermajority of independent directors, the appointment of lead independent directors and regular meetings of independent directors in executive session—further reinforce the independence and authority of the independent directors. The Price Fund Boards follow all of these practices. In addition, as noted above, the SEC recently issued a proposal that would require, among other things, that independent directors constitute at least 75 percent of fund boards and that the independent directors meet in separate sessions at least once each quarter. *See* SEC Fund Governance Proposals, *supra* note 17.

[21] *See, e.g.,* Section 201 of H.R. 2420, the "Mutual Funds Integrity and Fee Transparency Act of 2003," as passed by the U.S. House of Representatives on November 19, 2003; Section 204 of S. 1971, the "Mutual Fund Investor Confidence Restoration Act of 2003," as introduced by Senators Corzine and Dodd on November 25, 2003.

security. It most assuredly would also discourage many qualified persons from serving as independent directors of mutual funds.

Other Initiatives to Promote Investor Confidence

In addition to internal measures and regulatory changes to protect investors against the abusive mutual fund trading practices that have been the subject of the recent investigations and enforcement actions, it is appropriate to consider other ways to reinforce the protection and confidence of mutual fund investors. Certain current initiatives are discussed below.

Directed Brokerage

Under current law, a mutual fund manager is permitted to take sales of fund shares into account in allocating brokerage, subject to various conditions including that the broker must provide best execution. As a directly marketed fund complex, T. Rowe Price has never engaged in this practice for its own mutual funds. Although such "directed brokerage" is strictly regulated, prohibiting this practice may be the most effective way to address the conflict of interest issues it raises. The industry, through the Investment Company Institute, recently urged the SEC (and/or NASD) to adopt new rules for this purpose.[22] Consistent with the Institute's recommendation, the SEC recently proposed amendments to Rule 12b–1 under the Investment Company Act that would prohibit funds from using brokerage commissions to pay broker-dealers for selling fund shares.[23]

Rule 12b–1

In addition to proposing amendments to Rule 12b–1 to prohibit the use of fund brokerage commissions to pay broker-dealers for selling fund shares, the SEC is soliciting comments on whether it should make other changes to Rule 12–1. Given the many developments in fund distribution practices since the rule was adopted in 1980, a reevaluation of the rule is appropriate and timely. Due to the significance of the rule, its widespread use and related issues, it is important to solicit and consider the views of all interested parties before determining whether further changes to the rule should be proposed. Intermediaries who are selected by investors to assist them in making decisions about fund investments, and monitoring those investments, deserve to be compensated. The amounts and methods of compensation, and the disclosure of such to the investor, should all be part of this review. T. Rowe Price looks forward to studying the SEC's release and participating in this process.

Point-of-Sale Disclosure of Broker Incentives

Another issue that has been the focus of much attention recently involves the so-called "revenue sharing" arrangements in which a fund's investment adviser or principal underwriter makes payments out of its own resources to compensate intermediaries who sell fund shares. The principal investor protection concern raised by these payments is whether they have the potential for influencing the recommendations of the financial intermediary that is receiving them. Disclosure concerning certain types of revenue sharing arrangements already is required in fund prospectuses, and the industry has long advocated additional, point-of-sale disclosure by broker-dealers to help investors assess and evaluate recommendations to purchase fund shares.[24] Both the SEC and the NASD have recently proposed new point-of-sale disclosure requirements in this area.[25]

The SEC's proposal also would encompass other sales-related fees and payments, such as front-end and deferred sales charges and 12b–1 fees. T. Rowe Price strongly supports requiring point-of-sale disclosure concerning such fees and payments (as well as revenue sharing and differential compensation). Requiring broker-dealers to provide to investors who are considering purchasing mutual funds a separate disclosure document at the point of sale (as contemplated by the SEC's proposal) would help educate investors about the costs they are incurring in connection with the use

[22] Letter to The Honorable William H. Donaldson, Chairman, U.S. Securities and Exchange Commission, from Matthew P. Fink, President, Investment Company Institute, dated December 16, 2003. The Institute urged the SEC to curtail the use of soft dollars by all investment advisers, including mutual fund managers. T. Rowe Price supports the Institute's recommendations.

[23] *See* SEC Press Release 2004–16 (February 11, 2004), available at *http://www.sec.gov/news/press/2004–16.htm.*

[24] *See, e.g.,* Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Ms. Joan Conley, Office of the Corporate Secretary, NASD Regulation, Inc., dated October 15, 1997.

[25] *See* SEC Release Nos. 33–8358; 34–49148; IC–26341 (January 29, 2004) and NASD Notice to Members 03–54 (September 2003). Both proposals also would require disclosure concerning differential compensation paid to salespersons that could provide an incentive to favor one fund over another.

of the broker who is assisting them, while also alerting them to any potential conflicts of interest.

Conclusion

T. Rowe Price has been and continues to be committed to acting in our fund shareholders' interests. We believe most fund companies seek to do the same. The recent revelations of fund trading problems have highlighted to us and others responsible for fund investor assets the risks of doing otherwise. Many of the far-reaching regulatory changes proposed by the SEC and industry will assist fund managers, distributors, recordkeepers, and directors in fulfilling their objective of serving investor interests. At the same time, they will help eradicate inappropriate or illegal practices.

We are fortunate that investor confidence in mutual funds generally remains very high. But we must take advantage of the current problems to improve our policies and procedures so that we do not experience similar breaches of trust in the future. Our fund shareholders need to be confident that their interests do indeed come first.

PREPARED STATEMENT OF DON PHILLIPS

MANAGING DIRECTOR, MORNINGSTAR, INC.

FEBRUARY 25, 2004

Thank you for the opportunity to appear before this distinguished Committee. My name is Don Phillips, and I am a Managing Director of Morningstar, Inc., an independent investment research firm that provides data and analysis on mutual funds and other investments. Morningstar was founded in 1984, and today we cover more than 100,000 investments worldwide. Over 150,000 individual investors and 80,000 financial planners subscribe to our services. In addition, there are more than 2 million registered users of our investment website, *Morningstar.com.*

As the leading provider of mutual fund information to both individual investors and their financial advisors, Morningstar has had a front-row seat to witness both the rapid rise and the recent missteps of this important industry. We have seen a generation of American investors embrace mutual funds for their compelling combination of convenience, instant diversification, and professional management. The industry's rise has not solely been due to these merits, however. The mutual fund industry has also been the beneficiary of considerable good fortune. Numerous legislative acts, such as those allowing Individual Retirement Accounts, 401(k) plans, and 529 college savings plans, have encouraged investors to place billions of dollars into funds, greatly enriching those companies that offer them. As a result, mutual funds now occupy a central position in the long-term savings plans of more than 90 million Americans.

Given the privileged and highly important role that mutual funds now play, it would behoove the industry to redouble its commitment to the effective stewardship of the public's assets. Most individuals who work for mutual fund companies embrace this challenge, but the recent scandals make it abundantly clear that too many people in this industry were willing to forsake their responsibility in exchange for short-term personal profit. Sadly, these were not the acts of a few, low-level employees, but instead were violations of trust that took place at the highest levels, including company founders, CEO's, portfolio managers, and several current or former members of the Investment Company Institute's Board of Governors.

Investors are angered and confused by these scandals. Moreover, those institutions, such as pension plans, the financial press, and even the U.S. Congress, who steered investors toward funds have reason to feel betrayed. While few question the inherent benefits of mutual funds, it is clear that the industry has foolishly jeopardized its greatest asset—the public's trust. Investors need reassurances that their trust will not be further betrayed. In particular, they need to know: (A) That mutual funds operate on a fair and level playing field. (B) That checks and balances exist to safeguard investor interests. (C) That adequate information will be available to allow investors or their advisors to make intelligent decisions about their funds. (D) That mutual funds offer a reasonable value proposition

While market forces can and will do much of the work, the industry and regulators can take steps to ensure that mutual funds meet their obligations to the American public. Here are Morningstar's suggestions on each of these fronts:

Mutual Funds Must Operate on a Fair and Level Playing Field

One of the most disturbing aspects of the recent scandals has been the revelation that not all fund shareholders have been playing by the same set of rules. Too often,

rules imposed upon ordinary investors have been ignored by insiders or waived for high rollers, such as hedge funds. These breaches violate the core democratic promise of funds, which, after all, are designed to be mutual. Moreover, the loosening of these rules allowed for rapid trading of fund shares that created economic penalties for shareholders who played by the rules. It is time for the industry to define what constitutes abusive market-timing and then take meaningful steps to eliminate it. It goes without saying that whatever standards are set must be applied uniformly to all shareholders in a fund. It is also essential that late trading and the possibility of time-zone arbitrage in mutual funds be curbed immediately. We suggest a combination of redemption fees, fair-value pricing standards, and, until a better solution can be determined, a hard 4 p.m. close that would require all fund transactions to be at the fund company by 4 p.m. Eastern time in order to be transacted at that day's price.

Compounding the problems of mutual fund trading abuses has been disturbing evidence surrounding fund sales practices. When brokerage houses demand special payments or directed brokerage arrangements in exchange for including a fund on their preferred lists, they tilt the playing field, and they raise questions about the objectivity of the advice their brokers give. Investors deserve to know that the funds chosen for their portfolios are done so on the basis of their investment merit, not on their willingness to pay for shelf space at the brokerage house. It is time to eliminate directed brokerage deals and, at a minimum, better disclose pay-to-play arrangements.

Another area that warps the playing field is how different fund companies account for basic fund expenses. Investors currently pay a management fee to the fund management company to cover the cost of investment research. In addition, a host of operational expenses, such as custodial costs or the cost of trading securities, are charged directly to the fund. Two activities muddy the water. First, soft-dollar arrangements allow the fund's manager to dip into shareholder assets to pay for research, trading systems, office furniture, or other services. While funds clearly need these things, one would assume that these expenses would be included in the fund's management fee, not embedded in artificially high trading costs. Simply put, soft dollars provide a bigger profit margin for the fund's manager made possible by a hidden charge to shareholders. The opportunity for such double-dipping should be eliminated.

Rule 12b–1 fees further muddy the waters. Fund companies use these charges in part to promote the sale of new fund shares. Investors may benefit to a small extent from fund asset growth, but the advantages of a bigger fund are typically far greater for the asset manager. To the extent that 12b–1 fees compensate brokers for selling funds or for the services of fund supermarkets, we concur that these services help investors, but feel that the charge would be more properly paid directly to those parties, rather than through the expense ratio where all investors, not just those receiving the benefits of an advisor or a discount brokerage house, foot the bill.

While industry advocates will praise 12b–1 fees as a means of allowing investors greater choice in how (but not necessarily how much) they pay for advice, there is a danger to these fees that goes unspoken. When distribution costs are bundled into a fund's expense ratio, they begin to affect fund manager thinking. Unlike upfront sales charges, which are not included in the performance calculations investors see in places like *The Wall Street Journal*, the costs of 12b–1 fees directly lower a fund's total return and its yield. Managers who are saddled with high 12b–1 fees on their funds are at a distinct disadvantage to those who are not. If they simply buy the same securities as their lower-cost competitors, they are guaranteed to trail their rivals. Because fund managers are competitive people, it is not surprising that managers of higher-cost funds adjust their behavior in order to avoid this fate. Morningstar studies have shown that managers of funds saddled with high 12b–1 fees systematically take on greater risk than do managers of funds with lower expense ratios. For bond fund investors, this often means lower-quality bonds or added exposure to the risk of rising interest rates. For investors in equity funds, it may mean more concentrated portfolios or more speculative stock choices. In short, Rule 12b–1 fees offer investors both insult and injury—the illusion of cost savings and the likelihood of added risk.

At Morningstar, we think it is time to eliminate soft-dollar payments and to eliminate or seriously reconsider the role of 12b–1 fees in funds. Investors deserve a clear account of how their money is being spent. Allowing fund managers to dip into shareholder assets to promote asset growth or to offset research costs distorts the picture and makes it difficult for investors to align costs and benefits. Let's keep things clean and clear: Costs whose benefits flow primarily to the fund's advisor should be on the advisor's tab, not passed off as an investor expense. Moreover, distribution costs should be paid directly to distributors, not run through the fund's

expense ratio where they tempt managers to take risks they otherwise would avoid. Pricing schemes should not compromise the integrity of the investment management process.

Checks and Balances Must Be in Place to Safeguard Investors

It is not just the venality of the misdeeds in mutual funds, but the sheer number of offenses that is so disturbing to investors. It seems that every day another fund company is drawn into this mess. It is hard to fathom how so much wrongdoing could go undetected for so long. Sadly, these scandals raise obvious questions about the regulators who are supposed to safeguard investors. We support the increased funding for the Securities and Exchange Commission and would urge the Commission to continue to prioritize mutual fund regulation among the numerous important tasks it handles. Mutual funds are too important to the country's savings to be a back-burner issue with regulators.

Moves to put all fund regulation under the SEC strike us as inappropriate. The New York Attorney General's Office has demonstrated the significant benefits of a fresh set of eyes looking at the industry. We support the continued ability of individual States to bring actions against mutual fund companies when they see abuses. Mutual funds have been embedded into Government-sponsored savings plans for both retirement and college savings. It is valuable to have multiple agencies serving as checks and balances to safeguard investor interests, but we would ask that these groups coordinate their efforts. The public bickering between agencies in the recent investigations does nothing to reassure investors that their interests are paramount.

Ultimately, much of the burden of fund oversight must fall to the funds themselves, particularly to the fund directors. Much has been made of the importance of independent directors and an independent chairman. While these moves may be largely superficial, we think they are potentially beneficial. While in U.S. operating companies the chairman and the CEO are often the same person, such an arrangement presents a conflict of interest in funds that does not exist in operating companies. In an operating company there is only one party to which directors, be they independent or not, owe their loyalty—the firm's stockholders. In a mutual fund there are two parties to which the nonindependent directors owe their allegiance—one is the fund shareholder, the other is the stockholder in the fund management company. Only independent fund directors have a singular fiduciary responsibility to fund shareholders. Accordingly, we believe that fund shareholders may be better served when an independent chairman oversees their fund.

Of course, independence alone is no guarantee of good governance. We think a far more important issue is the visibility of the board. The typical fund investor is largely unaware of the corporate structure of funds. Few investors in, say, Fidelity Magellan think of themselves as the owners (alongside their fellow shareholders) of the fund. Instead, they think that Fidelity owns Magellan and they merely purchase its services. It is a notion that the fund industry doesn't discourage. Indeed, funds do little to draw attention to their corporate structure or the role of the board of directors, often relegating the names and biographical data of fund directors to the seldom-read statement of additional information.

To remedy this situation, Morningstar suggests that each fund prospectus begin with an explanation of the fund's corporate structure, such as the following:

> When you buy shares in a mutual fund, you become a shareholder in an investment company. As an owner, you have certain rights and protections, chief among them an independent board of directors, whose main role is to represent your interests. If you have comments or concerns about your investment, you may direct them to the board in the following ways . . .

By bringing more visibility to the fund's directors and by alerting shareholders to their role in negotiating an annual contract with the fund management company, the balance of power may begin to shift from the fund management company executives, where it now resides, to the shareholders, where it belongs.

If directors are to represent shareholders, they need to hear from them. However, most fund directors have far more contact with the fund's manager than they do with fund shareholders. Several years ago I met a director who served on the board of many funds at a large fund complex. He also served on the board of a Fortune 500 company. He told me that while he received a dozen or so letters a month from shareholders concerning the public company, he had never in more than 10 years received a letter from a fund shareholder. Fund boards have been out of sight and out of mind. It is telling that the whistleblowers at groups like Putnam did not even think to go to the fund boards. Fund boards must be more visible if they are to be an effective check for shareholders.

They must also be accountable. We suggest that the independent chairman be responsible for writing to fund shareholders in the fund's annual report to address the steps the board takes each year in reviewing the manager's performance and the contract that the fund has with the management company. By bringing to light these important review functions, one assures that the structural safeguards of the investment company will work in practice, as well as in theory. We would also advocate a stronger role for fund directors in reviewing all communication between the fund management firm and fund shareholders, including marketing materials designed to attract new investors. The fund's communications should effectively explain the fund's investment strategy and the potential risks it may incur. By helping to establish rational performance expectations, fund boards would do a real service for both current and future shareholders.

Investors Must Have the Information to Make Intelligent Decisions About Funds

Transparency is the hallmark of the American financial system and one of the reasons that U.S. investors have put so much trust in mutual funds. Indeed, the amount of disclosure on funds in the United States is superior to that of any other country. Yet, at the same time, the disclosure requirements for funds fall well behind the standards set by publicly traded stocks in the United States. Given the rising importance of funds to so many Americans' financial security, we think it would benefit the industry to strive for the highest standards possible. While transparency can be a burden, it is also a tremendous asset in establishing and retaining trust, the very quality upon which mutual funds are based.

All investors deserve to know if their interests are aligned with management's. Every week, we speak with mutual fund portfolio managers who tell us that before they buy stock in a company, they look to see how management is compensated. They want managers who "eat their own cooking" and whose interests are aligned with theirs. That is why institutional equity managers have long demanded and received detailed information about senior corporate executives' compensation and their holdings of company stock. In fact, stock investors would protest loudly if this information were denied to them. Why, then, are fund shareholders not given the same insights into their investments?

Consider the case of a manager's holdings or trades in his or her fund. An equity investor has access to detailed information on the purchases, sales, and aggregate holdings of senior executives and other insiders at an operating company. Stunningly, fund investors are denied access to the very same data about the managers of their funds. While it is easy to appreciate why management might not wish to provide such data, it is hard to argue why an investor shouldn't have the right to see it. Indeed, such sunlight might well have been beneficial in the recent cases of several Putnam portfolio managers or Strong Funds' Chairman Richard Strong, who have been accused of market-timing their own funds. Can you imagine these executives engaging in such actions if they knew their inappropriate trading activities would become public information? Disclosure can be a powerful deterrent.

Even the aggregate investment that managers have in their funds is shielded from fund shareholders' view. While any equity investor can see exactly how many shares of Microsoft Bill Gates owns, there is no way for a fund investor to see if his or her manager has any "skin in the game." In the wake of the recent fund scandals, several mutual fund portfolio managers have stated publicly that because they invest heavily in their own funds, the kinds of trading abuses seen in other shops would not happen at theirs. This statement is a virtue that any fund manager can claim, but none has to prove. Why would such information that has long been disclosed about corporate insiders not be available about fund insiders?

The same principle applies to management compensation and the incentives it creates. Disney shareholders know to the penny what Michael Eisner is paid to run their company. Like all holders of publicly traded stocks, they receive a statement from the compensation committee with their annual proxy materials outlining how the committee has structured the CEO's pay and on which metrics his or her bonus is based. It is not uncommon for these materials to include a CEO's entire employment agreement. Given the high level of disclosure on operating companies, it is hard to reconcile why no disclosure whatsoever is provided on fund manager compensation.

Fund investors do not know if their manager's bonus is tied to short-term returns or to rolling 5-year returns, to pretax or to aftertax profits. If the manager's pay is linked to pretax returns, surely a manager will be less concerned about the tax consequences of his or her decisions. How can this not be material information to an investor considering placing a fund in either a taxable account or an IRA? In addition, one would hope that a fund manager's compensation is tied to fund per-

formance, rather than to the fund's asset growth. A manager's incentive should be to manage, not to sell. But, with no compensation disclosure, how can a fund investor be sure? If mutual funds are indeed investment companies, let's treat them as companies and give fund investors the same level of disclosure that stock investors have long enjoyed.

Finally, there is the issue of funds disclosing their portfolio holdings in a uniform and timely fashion. Such disclosure allows investors to see how their money is being managed and to more intelligently deploy funds within their portfolio. Many of the funds sold to the public as "diversified" growth funds during the late 1990's held more than half their assets in technology stocks. An investor who thinks he has a diversified portfolio, but who, in fact, has a massive sector bet, is a disaster waiting to happen—a fate that too many fund investors learned the hard way when the tech bubble burst in 2000.

The only way to intelligently troubleshoot a portfolio of funds is to have accurate and timely data on the securities within the funds. While most investors won't sort through detailed lists of fund holdings, there are financial advisors and research companies who will. In addition, the press and academics would be better able to research the fund management industry if they had access to such information. We see no need for instantaneous disclosure of fund holdings, but full portfolio disclosure at monthly intervals with an appropriate lag time to protect the manager's trading would greatly facilitate the research process and increase the odds that the right investor ends up in the right fund. If funds are not deployed wisely, they cannot possibly meet their obligations to investors. Barriers to quality research that would help investors make better use of their funds need to be removed whereever possible.

Mutual Funds Must Show that They Offer a Compelling Value Proposition

Ultimately, mutual funds must demonstrate to investors that they offer a compelling value proposition. While the market will be the final arbitrator, fund companies can and should disclose fund costs in a fashion comparable to other professional fees, so that investors can make informed choices and the market can operate efficiently. Investors have moved their assets toward lower-cost funds over time, but they have done so not because funds clearly disclose costs, but because investors ultimately see the debilitating effect of high costs on long-term performance. Why should we continue to subject investors to these damages when there are easy steps that can be taken to alert investors up front to the true cost of their funds?

Funds currently state their costs in percentage terms, not dollars, and they state them as a percentage of assets entrusted to the manager, not in terms of the percentage of the investor's likely gain-potentially a far more relevant number. For example, an investor with $300,000 in a bond fund is told that his fund has an expense ratio of 1.5 percent. However, if an investor expects bonds to return 5 percent per year over the course of his investment horizon, that 1.5 percent expense ratio in reality reflects a 30 percent annual toll on the likely returns he will receive from his investment. While establishing expected returns for asset classes is problematic, it is clear that the way fees are currently reported to shareholders dramatically understates their impact on returns (1.5 percent versus 30 percent).

The U.S. Government has established a fine precedent for the fund industry to follow in how it states, in dollars, the exact amount that a worker has deducted from his paycheck for Federal taxes, State and local taxes, Social Security, and Medicare. Workers can decide for themselves if they think the payments they make represent reasonable value for the services provided because they are allowed to see the exact cost in dollars of the services. Wouldn't the same basic level of disclosure be helpful to investors making decisions about funds?

For many middle-class Americans, mutual fund management fees are now one of their 10 biggest household costs, yet the same individual who routinely shuts off every light in his house to shave a few pennies from his electric bill is apt to let these far greater fund costs go completely unexamined. Stating these fees in a dollar level that corresponds with an investor's account size is an important first step. We have truth-in-lending laws that detail to the penny the amount a homeowner will pay in interest on his mortgage. It is time for truth-in-investing rules that would bring the same common-sense solution to mutual funds. And of course, in fairness to mutual funds, the same standards should be applied to all investment services, including exchange-traded funds, variable annuities, and separately managed accounts.

Conclusions

Given the central role funds now play in the retirement savings of our country, it makes sense to debate the rules governing this industry. At the same time, we

do not believe that legislative solutions alone can safeguard investors. Public scrutiny and market forces also play a crucial role. In the wake of the recent fund scandals, we have seen Larry Lasser, Putnam's longstanding CEO, resign his position in disgrace. We have seen Strong Funds' Chairman Richard Strong forced to sell his business for a price possibly less than half what he had been offered just 4 years ago. And, finally, we have seen James Connelly of the Alger Funds sentenced to prison for his role in covering up evidence surrounding these scandals. The message to every fund executive is clear: If you violate the public's trust you can lose your reputation, your fortune, and your freedom. That is a lesson that will guide this industry for years to come.

Still, we believe that there are additional steps that can be taken to protect the investing public. Specifically, we endorse these 10 steps:

- Close the door to timing and late-trading abuses.
- Eliminate directed brokerage deals and better disclose pay-to-play arrangements.
- Eliminate soft-dollar payments.
- Eliminate or seriously reconsider the role of 12b–1 fees.
- Maintain vigilant and appropriately funded regulatory oversight.
- Make fund directors more visible and accountable to shareholders.
- Disclose fund manager trading in their funds.
- Disclose fund manager compensation.
- Improve portfolio holdings disclosure.
- State actual fund costs in dollars, so the market can work more efficiently.

Mutual funds have a proud history, but the recent scandals have badly damaged the industry's credibility. Collectively, legislators, regulators, and industry leaders must rebuild the public's trust in mutual funds. Investors need assurances that the playing field is level, that safeguards exist, that their manager's interests are aligned with theirs, and, ultimately, that funds represent good value. By addressing these concerns, the industry can get back on track to helping investors meet their goals and secure a safer future for their families.

PREPARED STATEMENT OF GARY GENSLER

FORMER UNDER SECRETARY FOR DOMESTIC FINANCE

U.S. DEPARTMENT OF THE TREASURY

FEBRUARY 25, 2004

Introduction

Chairman Shelby, Ranking Member Sarbanes, Members of the Committee, thank you for the opportunity to testify today on how to better align the mutual fund industry with the interests of investors. Since I last appeared here during my tenure as Under Secretary of the Treasury, I co-authored a book, *The Great Mutual Fund Trap,* to present common sense investing advice to middle-income Americans.

The recent mutual fund scandals have shaken the confidence of these very investors. They are now asking: What went wrong? How do they best protect their savings? What can their Government do to better protect investors in the future?

I believe that, at its core, the scandals have revealed the need for substantive reform regarding how mutual funds are governed and operated in America.

In today's global economy, we simply have no choice but to ensure that America has the fairest and most efficient capital markets in the world. Mutual funds are a dominant factor for a majority of American families trying to save for retirement. They are amongst the largest sources of capital for corporate America. If mutual funds were to truly operate in the best interest of investors it would increase investors' returns, increase retirement savings, and lower the cost of capital for the overall economy. This is ever more critical as we prepare for the retirement of the baby-boom generation.

Congress long ago recognized the inherent conflicts of interest that exist between investors and those who mange investors' money. Responding to an earlier era's financial scandals, Congress passed the Investment Company Act of 1940 (1940 Act). The 1940 Act set up a system of mutual fund governance whereby non-interested mutual fund directors (independent directors) must independently review and approve all of the contractual relationships with the management company and the financial community. Congress understood that these relationships presented unavoidable conflicts and could significantly affect investors' overall returns.

It is largely that system—independent mutual fund directors acting as gatekeepers for the benefit of investors—which we have in place today. It is that system that I believe deserves serious review and reconsideration.

Only Congress can adequately address these issues through reform legislation. While the Securities and Exchange Commission (SEC) is pursuing an active agenda of reform, it cannot act alone on all of the necessary reforms to best align the interests of mutual funds with those of the investors they are supposed to serve.

Background

The whole idea of a mutual fund is, as the name suggests, *mutuality.* Funds allow investors to share the costs of professional money management, in the nature of a cooperative. Mutual funds offer investors a chance at the superior long-term performance of equity investing, and a convenient way to buy bonds. They offer risk reduction through diversification as most funds own a broad spectrum of the market. Finally, when compared with the full-service brokerage commissions of the time, at first mutual funds' costs were relatively attractive. Legally, investors actually have collective control over their mutual funds. The company managing the assets is distinct from—and legally simply a contractor hired by—a mutual fund. Investors are represented by a board of directors which has a fiduciary duty to oversee their investments and hire the money management company (known as an "adviser") to invest it. In theory, the adviser works for investors to get the best returns for the lowest costs and risks. That is, at least in theory.

Mutual fund companies, as distinct from the funds themselves, however, have their own shareholders and profits to consider. They have a primary responsibility to their shareholders above any duties to the investors in the many funds they manage. They charge high management fees even though those fees come directly from investors' returns. They generally are willing to take added risks in an effort to attract assets in rising markets. And they trade frequently, even if that increases trading costs and investors' short-term capital gains taxes.

In practice, mutual fund investors have very little power over "their" company. Mutual funds are set up by advisers, not by individual investors. Funds have no employees of their own. All of the research, trading, money management, and customer support staff actually work for the adviser.

Mutual fund directors serve part-time and rely on the adviser for information. The adviser initially selects directors for new funds and often recruits new directors for established funds. Approximately 80 percent of mutual fund boards are even chaired by someone affiliated with the adviser. Furthermore, fund companies generally set up a pooled structure, whereby fund directors serve on groups of boards for a fund family. The Investment Company Institute (ICI) recommends use of such "unitary boards" or similar "cluster boards" in the name of efficiency. Not surprisingly, mutual fund boards fire their advisers with about the same frequency that race horses fire their jockeys.

The Role of Fund Directors

The 1940 Act establishes specific roles for mutual fund directors. In particular, Section 36 of the 1940 Act imposes a fiduciary duty on directors with respect to fees paid to advisers. Section 15 of the 1940 Act requires that the independent directors annually review and approve the contracts with the investment adviser and the principal underwriters. Rule 12b–1 requires a similar review of the distribution contracts. According to the late U.S. Supreme Court Justice William Brennan, the 1940 Act was designed to place unaffiliated fund directors in the role of independent watchdogs, to furnish an "independent check upon the management of investment companies." [1]

In speaking to the inherent conflicts and potential for abuse and overreaching, SEC Chairman Donaldson said just 2 weeks ago:

> This problem is nowhere more in evidence than in the negotiations over the advisory contract between the manager and the fund. The money manager wants to maximize its profits through the fees the fund pays. The fund's shareholders want to maximize their profits by paying as little as they can for the highest level of service. The fund's board of directors serves as the shareholders' representative in this negotiation.[2]

This duty, however, has never been interpreted very stringently. In the landmark case on the matter, the second circuit court of appeals ruled in 1982 that:

[1] *Burks* v. *Lasker,* 441 U.S. 471, 484 (1979).
[2] SEC hearing (February 11, 2004).

> To be found excessive, the trustee's fee must be so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining.[3]

Over the subsequent years, the Gartenberg standard has proved to be insurmountable. No shareholder has subsequently proved a violation of the Gartenberg standard. And while it was initially found with regard to the fiduciary duty of the adviser (under Section 36(b)) courts have allowed its use as the standard for directors as well. The SEC also has never sued a fund director for failing to review adequately an advisory agreement.

In practice, fund directors have a difficult time striking a proper balance between working with the adviser and vigorously pursuing investors' interests. Directors, in essence, are recruited by the fund companies. Directors generally serve on a multitude of the fund family's boards. They naturally serve only part time and rely solely on the management company for all of their information. There are not even any direct employees of the fund or the board. The directors also have been informed of the legal standards and that until recently there has been only limited actions by the SEC and the courts. How many well-meaning directors would wish to make waves in this environment?

Why Governance Matters—Excess Costs Lower Retirement Savings

High mutual fund costs take a serious bite out of Americans' retirement savings. The SEC noted the potential effects on retirement savings when they stated: "A 1 percent increase in a fund's annual expenses can reduce an investor's ending account balance in that fund by 18 percent after 20 years." [4]

Over a lifetime, results can be even more dramatic when compared with low-cost passive index investing. Investing in low-cost index funds can lead to nearly twice as much savings by retirement than with the same amount actively invested (based upon just 2 percent more earnings per year).[5]

In total, investors can expect costs totaling close to 3 percent to disappear each year in an actively managed stock fund. Those investors who invest in a fund with sales loads (close to one half of all investors) can expect costs averaging over 4 percent per year. While fees for bond funds are modestly lower, they still overwhelm the expected returns on bonds, particular in today's low-interest rate environment.

Mutual fund companies impose costs on investors approaching $100 billion annually. These mutual fund costs are disclosed to investors:

- Monthly management, administrative, and distribution fees averaging well over 1 percent per year. A review of the 2,297 actively managed stock funds in the Morningstar database shows an average expense ratio of 1.49 percent.[6]
- Sales loads, charged by half of all actively managed mutual funds, averaging 3.9 percent.[7] With an average holding period of just over 3 years, investors can pay an additional 1.2 percent per year.

While investors may not pay particular attention to these costs, at least they are disclosed. Also, fund directors are legally required to pay attention to them.

There are some very important costs, though, which go undisclosed. They are hard for investors to measure and they do not show up on any statement. Mutual fund directors also have a more limited legal role in these costs. As investors' representatives, however, I believe, they actually should be very engaged in these costs.

- Portfolio trading costs—the typical active equity fund manager turns over their entire portfolio once every 18 months, incurring brokerage costs and bid/ask spreads approximating ½ to ¾ percent of assets each year.
- Excess capital gains taxes—adding costs of 1 to 2 percent of assets per year—are incurred as portfolios are rapidly traded. While helpful to the U.S. Treasury, this pervasive triggering of short-term capital gains tax is particularly costly for investors in the new 15 percent long-term capital gains rate environment.

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[3] *Gartenberg* v. *Merrill Lynch Asset Management, Inc.,* 694 F.2d 923 (2d Cir. 1982), *cert. denied,* 461 U.S. 906 (1983).

[4] SEC Report of the Division of Investment Management of Mutual Fund Fees and Expenses, (January 2001): 5.

[5] For example, if a worker saves just $100 per month over a 40-year career and earns 8 percent annually, they can retire with a $348,000 nest egg. Invest in actively managed funds and the likely nest egg—$199,000—fully 43 percent less money available for retirement.

[6] Morningstar Principia Pro as of December 31, 2003.

[7] Morningstar Principia Pro as of December 31, 2003. Search was for all U.S. equity mutual fund share classes charging a sales load, excluding index funds, exchange-traded funds, and institutional funds—3,996 funds in all. The 3.9 percent came from adding the average front-end and back-end load.

- The opportunity cost of holding idle cash lowers returns about 0.4 percent each year, on average, during the last 10 years. (Though even more during the strong market of last year.)

Why Governance Matters—Soft Dollars

Hidden within portfolio trading costs is something Wall Street calls "soft dollars." This is where an adviser, with the acquiescence of the funds' directors, benefits itself at investors' expense.

The mutual fund industry's educational material on the role of directors has this to say about "soft dollars." [Emphasis added]:

> Directors also review a fund's use of "soft dollars," a practice by which some money managers, including mutual fund advisers, use brokerage commissions generated by their clients' securities transactions to obtain research and related services from broker-dealers *for the clients' benefit.* Directors review their fund adviser's soft-dollar practices as part of their review of the advisory contract. They do this because *services received from soft-dollar arrangements might otherwise have to be paid for by the adviser.*[8]

What is hard to figure out is how soft-dollar payments can ever be "for the clients' benefits" when they "might otherwise have to be paid for by the adviser." A portion of every commission will be retained by the broker as payment for research advice or other services normally paid for by the fund company. Basically, any expense that the fund company can direct to the fund's broker adds to the fund companies' profits at the expense of individual funds and their investors.

Why Governance Matters—The Sad Averages

All of these costs have their effect. Looking at the results over the last 10 years, Morningstar data shows that the average actively managed diversified U.S. equity mutual fund fell short of the market by 1.4 percent annually. Annual fund returns of 9.2 percent compared to the overall market return of 10.6 percent annually, as measured by the Wilshire 5000.

Furthermore, currently reported performance results include only those funds that survived the entire period. The many funds which have been routinely merged or liquidated are not still included in industry statistics. Looking at 10-year returns of currently active funds in 2004 will by definition exclude all the unfit funds that closed up shop during the last 10 years.

This phenomenon is known as survivorship bias. It is like judging the contestants on a reality TV show simply by looking at the last few people left on the island. If someone asked a viewer how interesting the contestants were, they would probably forget the ones who were voted off in the first few weeks. What were their names again?

The most comprehensive look at survivorship bias was conducted by Burton Malkiel, who concluded that such bias was considerably more significant than previous studies had suggested. For the 10-year period of 1982–1991, survivorship bias inflated average industry returns by 1.4 percent per year.[9] Furthermore, the number of liquidating funds is rising. With 4 to 5 percent of all funds disappearing each year, survivorship bias today is likely to be even greater than during this earlier period.

Why Governance Matters—Distribution & Revenue Sharing Arrangements

The mutual fund industry increasingly relies on others—brokers, insurance companies, and financial planners—to sell its products. So while initially hesitant to promote a competitor's products, brokers later developed "revenue sharing arrangements" whereby they would get paid for every new sale they made. Most mutual fund families feel that they have to pay, lest they lose access to new assets and market share.

Mutual fund companies do not eat the cost of paying these sales forces. They pass that cost along to investors, either through a 12b–1 fee, a sales load, or in the form of directed brokerage commissions. In certain recent cases, these arrangements have been in direct conflict with current SEC rules. In aggregate, 12b–1 fees cost investors approximately $10 billion per year while sales loads are in excess of $20 billion per year.

There is absolutely no reason, however, for investors to pay loads or 12b–1 fees. They are not like brokerage commissions, which are necessary to execute a trade

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[8] The Investment Company Institute, "Understanding the Role of Mutual Fund Directors" (1999): 16.

[9] Malkiel, Burton G., "Returns from Investing in Equity Mutual Funds 1971 to 1991," *Journal of Finance* 50 (June 1995): 549.

on an exchange. Mutual funds are charging investors loads and part of 12b–1 fees to issue them new fund shares. The other part of 12b–1 fees goes to advertising. Brokers like both because they get to share in the action as additional compensation. Sales loads do not even help offset other costs. Expense ratios for load funds are higher than for no-load funds, with an average of 1.89 percent per year.[10] And as a group, load funds actually earn lower average returns than no-load funds . . . even without taking the loads into account.

Why Governance Matters—Recent Scandals

Mutual fund investors have had a series of wake up calls this past year. The series of scandals has helped to highlight the potential for investors to take a back seat to the inherent conflicts of interest lurking within the industry.

In a pursuit of assets, many mutual fund companies entered into questionable activities. Some sophisticated investors, such as certain hedge funds, were allowed to invest in mutual funds based upon stale prices. These practices, known as "late trading" and "market timing" were not readily available to the general public. With "late trading," intuitional investors were allowed to invest after the legally mandated 4 p.m. close, thus getting the benefit of further market developments while still paying the price as of 4 p.m. In "market timing" sophisticated investors were allowed to trade in and out of funds on very short holding periods in an effort to take advantage of stale prices related to international stocks. Most of these funds had actually publicly stated to their investors that they forbade such activity. To allow this for the privileged few was disadvantageous to the vast majority of retail investors.

Another set of problems arose around brokers incorrectly charging investors when purchasing load funds. In many of these funds, discounts are advertised for larger purchases. Unfortunately, many brokers were lax in recognizing these discounts or "breakpoints."

There also have been questionable practices which have gotten less public attention, but are no less troubling. In particular, many mutual fund companies use "incubator" funds and the allocation of initial public offerings (IPO's) and other hot stocks to boost the reported results of new funds. Other fund advisers also have been advising hedge funds and potentially favoring those funds internally.

Market Breakdown

The mutual fund industry is certainly competitive, with significant disclosure of its costs. So why haven't markets worked better to protect investors?

I believe that this is due to a number of factors, including: (i) investors' collective willingness to put their faith in experts while chasing after recent performance; (ii) the effective advertising of the financial industry; (iii) the unique way the industry charges for its services; (iv) the many conflicts of brokers and financial planners; and (v) the practical day-to-day barriers in switching mutual fund families.

There are thousands of funds and hundreds of fund companies competing in the market. That does not mean, however, that the mutual fund industry competes on cost. There are hundreds of casinos in Las Vegas, but that doesn't mean that you will find one where the odds are in your favor.

Mutual funds compete on service and the expectation of earnings performance. Most Americans tend to pick actively managed funds in the hope of relying on the experts to beat the market. Worse, they pick funds based upon last year's best performers or "hot" funds—expecting them to out perform the market once again next year.

Winning funds of the past, however, are unlikely to be the winning funds of the future. In perhaps the most important study of the factors affecting mutual fund performance, it was found that, basically, past performance does not predict future performance.[11] If you take the top 10 percent of funds in a given year, by the next year, 80 percent of those funds have dropped out of that top 10 percent ranking. For the top 20 percent of funds, 73 percent drop out the next year. For the top 50 percent of funds, roughly 45 percent fall out the next year. That is not much different from what you would expect from random chance.

Regardless, mutual fund companies spend significant advertising dollars luring investors to this loosing strategy. Advertisements are a poor guide, however, for in-

[10] Morningstar Principia Pro as of December 31, 2003.

[11] Carhart, Mark M., "On Persistence in Mutual Fund Performance," *Journal of Finance* 52 (March 1997): 57.

vestors trying to decide on a mutual fund. Researchers examined 2 years of mutual fund advertising in *Barron's* and *Money* magazine.[12]

The study reached three conclusions:

- First, not surprisingly, the advertised funds had performed well in the year *before* the advertisement was run. The *pre*-advertisement returns of those funds over the past year were 1.8 percentage points better than the S&P 500 Index.
- Second, the advertisements were extremely effective in attracting new money to the funds. Compared to a control group, advertising appeared to increase inflows 20 percent over what one would otherwise have expected.
- Third, and most significantly, the *post*-advertisement performance of the funds was quite poor. The funds' *post*-advertisement performance over the next year *trailed the S&P 500 by 7.9 percentage points.*

Mutual fund advertising is a classic example of closing the barn door once the horse has left. Mutual funds also have constructed a unique system whereby costs are practically invisible—another reason why traditional market forces break down. We all have to write a check to our utility or mortgage company, but we never pay a bill for mutual fund management. Such costs are simply deducted from our monthly returns, or taken off the top if we buy a load fund. Other significant costs are not even adequately disclosed, such as portfolio trading costs. In addition, markets are volatile while trending up. This leaves most investors focused on total returns rather than how costs affect those returns.

Investors also are faced with brokers and financial planners touting suggestions and advice which often have the added benefit of lining that broker's or planner's pocket. When investors do consider changing mutual funds, they generally turn to these same brokers and financial planners. There are some practical barriers to switching funds, as well. A significant portion of mutual fund investors now have some savings in 401(k) plans or 403(b) plans. These plans and the fund options are selected by their employers. Many other investors are hesitant to make investments with a fund family other than where they might have a linked money market account.

Policy Recommendations

To promote retirement savings and the markets, I believe that Congress and the SEC should enact significant mutual fund reforms. While the SEC and other law enforcement agencies may be the first line of defense, I think that there is an important role for Congress to play. The SEC may go only so far under current statute. In addition, Congress can bolster the actions the SEC might take on their own.

In this regard, I recommend that this Committee give serious consideration to: (a) strengthening fund governance; (b) restricting payments of soft dollars and 12b–1 fees; (c) enhancing fund disclosures; and (d) adopting certain fixes directly raised by the recent scandals.

Mutual Fund Governance

The 1940 Act sought to address inherent conflicts of interest by relying upon independent directors to promote investors' best interests. The recent scandals and the persistence of high fees and other costs have revealed fundamental weaknesses in this system of governance. I believe that Congress and the SEC should now vigorously address these weaknesses by: (i) clarifying the duties of independent directors and the standards to which they are held; (ii) tightening the definition of independence; (iii) prescribing how independent directors are selected; and (iv) increasing their numbers and requiring the chair to be independent.

Governance—Duties & Standards

I believe that the most important thing that Congress can do in promoting reform is to make clear—in statute—the duties which independent directors hold to investors and tighten the standards to which they will be held. In essence, I believe that directors should act on behalf of the investors as if they were owners.

While the 1940 Act is specific as to the many duties of directors, until the recent scandals, the mood in the boardroom has been all too accommodating. In particular, there is significant evidence suggesting that fund directors do not actively pursue cost reductions or vigorously negotiate major contracts related to advisers, brokers, or portfolio trading. These are the largest controllable costs of a mutual fund.

[12] Jaij, Prem C., and Joanna Shuang Wu, "Truth in Mutual Fund Advertising: Evidence on Future Performance and Fund Flows," *Journal of Finance* 15 (April 2000): 937.

What if mutual fund directors were to vigorously negotiate fees and other costs? Could they not confer far more significant benefits to investors than they do under the current governance system? Would not retirement savings increase in America?

While I am not suggesting mandating "request for proposals" by mutual funds, I do believe that the 1940 Act should be amended to include a general fiduciary duty for directors to act with loyalty and care and in the best interests of the shareholders. It may be appropriate, as well, to mandate that the SEC promulgate rules for directors in carrying out these fiduciary duties. This would provide impetus for independent directors trying to balance their relationships with the investment adviser and others with inherent conflicts of interest. For instance, the Act could require that the independent directors formally meet without interested parties while reviewing and discussing the material contracts. It could also spell out a list of issues which must be considered when approving contracts. Most significantly, the 1940 Act could require true arm's-length negotiations. Imagine any other board of directors fulfilling its fiduciary duties without requiring similar efforts related to its principal supply contracts.

I also believe that Congress should amend or repeal the Gartenberg Standard. This legal standard is at the very heart of the loose oversight currently evidenced by mutual fund boards.

Finally, I believe that independent directors should be required to ask for and receive more relevant information prior to entering into major contracts, not just the advisory contract. Section 15 of the 1940 Act could be expanded, requiring that the SEC promulgate rules from time-to-time to best accomplish this. In particular, the SEC should require independent directors to consider the amounts that advisers charge pension plans and other parties for similar advisory services.

A study conducted in 2001 showed that the largest mutual funds pay twice the amount to their advisers than public-employee pension plans do for the same services.[13] In some cases, mutual fund advisory fees were 3 to 4 times higher than those of pension funds. While challenged by the ICI, the study still raises legitimate questions for policymakers and independent fund directors. Pension funds negotiate for lower fees, while mutual fund shareholders can only rely on their directors to do so. Trustees of public pension plans and corporate retirement plans switch asset managers on a regular basis, due to fee, performance or service issues. Mutual fund directors should at least benefit from the best direct comparisons on fees. I have no doubt that they could be made available, if required in law.

Governance—Definition of Independence & Selection Process

While the 1940 Act currently contains a definition of an independent director, I believe that it is prudent to tighten that definition and provide for an independent mechanism for the recruitment and selection of such directors. Sections 10 (and its related definitions) of the 1940 Act could be amended to assure that noninterested directors not have any material employment, business or family relationship with the investment adviser, significant service providers, or any entity controlling, controlled by, or under common control with such companies. In addition, the recruitment and selection of such directors should be by the independent directors or by an independent nominating committee.

Governance—Independent Chair & Percentage of Independent Directors

The 1940 Act currently mandates that at least 40 percent of mutual fund directors be independent. The SEC, in 2001, required mutual funds operating under a series of SEC exemptions to have at least 50 percent of their directors be independent. The SEC, in response to the recent scandals has proposed rules to move this percentage to 75 percent and require that the board chair be independent, as well. I support these changes as they should change the dynamics in the boardroom. In particular, the chair sets the agenda and tone of board deliberations. There is no way that a chair who also works for the investment adviser can satisfactorily serve two masters. By way of analogy, for those who might doubt the importance of the chair, think of all the energy that goes into securing the chairs of Senate Committees.

I do believe, however, that it would be far better to incorporate these requirements directly in the 1940 Act. It is better for Congress to act on such a material provision of law, rather than have the SEC, a regulatory agency, to mandate its adoption particularly through indirect means. In addition, in a moment of future confrontation between an independent board and a fund company, the fund may avoid the SEC rule by declining the various exemptions.

[13] Brown, Stewart, and John Freeman, "Mutual Fund Advisory Fees: The Cost of Conflicts of Interest," *University of Iowa Journal of Corporation Law* (August 2001): 609–73.

To assure the necessary change in behavior of boards, however, more is needed than simply changing the number of independent directors and mandating an independent chair. The great majority of funds already have a substantial majority of independent directors. In fact, approximately 20 percent already have independent chairs, including some of those funds caught up in the recent scandals. While it would be a positive step, current law already requires that independent directors review and make the key decisions of the board. That is why I believe that the most important governance reform is to clarify the duties of independent directors and tighten the standards to which they are held.

Restricting Soft Dollars & 12b–1 Fees

Beyond changes to encourage better mutual fund governance, I believe that Congress should give serious consideration to restrictions on soft-dollar arrangements and 12b–1 fees. Both of these practices exist as they do as a result of specific SEC actions. Both of these practices also have been associated with a long history of conflicts of interest, and may have outlived their purposes.

The use of soft dollars was significantly broadened under an SEC release in 1986 (interpreting Section 28(e) of the Securities Exchange Act of 1934, which allows paying more than the lowest available commission). Mutual fund companies enter into soft-dollar arrangements with brokers at the expense of the mutual funds which they manage. While soft-dollar arrangements can be used to support independent research efforts, they are often used for other expenses as well. They also diminish fund managers' pursuit of best execution for portfolio transactions.

The SEC has put out a concept release seeking comments on soft-dollar arrangements, but the Congress may wish to significantly restrict or possibly prohibit the current practice. Short of an outright prohibition, mutual funds should be required to disclose the amount by which any soft-dollar arrangement are picking up costs for the fund company and this amount should be added to expense ratios.

Rule 12b–1 was promulgated in 1980 in an effort to bring the benefits of economies of scale to investors. The theory originally was that by helping fund companies generate cash for marketing, funds could grow faster and share economies with investors. Unfortunately, investors have seen few benefits from scale in these funds. The evidence clearly shows that funds with 12b–1 plans simply have higher expense ratios and poorer performance than non-12b–1 funds. The time has come to look seriously at repealing Rule 12b–1. The SEC proposed an amendment to Rule 12b–1 this month which would ban the practice by mutual funds of directing commissions from their portfolio brokerage transactions to broker-dealers to compensate them for distributing fund shares. I agree with these changes but would add that Congress might want to consider the effects of other revenue sharing arrangements, as well. These arrangements call into question the ability of investors to receive unbiased financial advice from their financial planners or brokers. By analogy, patients do not wish to see their doctors receive direct commissions when deciding on the appropriate medicine to prescribe.

Greater Disclosure

The mutual fund industry currently provides a considerable amount of disclosure to the investing public. Additional disclosures, however, may assist investors and further guard against inherent conflicts. While I think that the most important reforms relate directly to governance, I offer the following thoughts on additional possible disclosures to benefit investors.

First, while the direct costs of management fees and sales loads are disclosed, many of the indirect costs are not. In particular, portfolio trading costs are generally not disclosed. This is somewhat remarkable given their significance to investor returns. They are also one of the largest controllable costs of mutual funds. I believe that it would be beneficial to disclose total transactions costs, commissions as well as an estimate of the costs of bid/offer spreads. If pursued, this would be most helpful if disclosed along with management fees as a percentage of average assets.

Second, the mutual fund industry relies heavily on others—brokers, insurance companies, and financial advisers—to sell its products. Additionally, fund companies actively compete to win 401(k) and 403(b) plans from large corporations and institutions. Recognizing their commercial leverage, brokers have developed revenue sharing agreements whereby they get paid handsomely for new sales. Large corporations and institutions have developed somewhat similar arrangements whereby they receive part of the mutual fund fees on plan assets. Consideration is appropriate to greater disclosure of these revenue sharing arrangements.

Third, bringing greater transparency in the area of governance may bring greater discipline. The SEC has this month proposed a rule to require improved disclosures regarding the reasons for a fund board's approval of investment advisory contracts.

I believe that this rule could be extended—by statute—both as it relates to the negotiations with the adviser and to include other major contracts. In addition, disclosure of portfolio manager compensation and fund ownership would be helpful.

Fourth, given the natural desire of fund companies to ignore the poor results of liquidated or merged funds, it would be helpful to require fund companies to maintain such disclosure on their websites. Survivorship bias has a perfectly innocent explanation. When investors are trying to decide with which mutual fund family to invest, however, they could benefit by seeing a firm's entire track record. Many outside services and publications would also summarize the information, once it was made publicly available.

Fifth, there is a significant relationship between risk and returns. Many observers focus on risk adjusted returns to compare investments. Based upon modern theories of investing, risk adjusted returns are a way of comparing investments of different risks. There are many services that compute such statistics. It may be worthwhile considering requiring fund companies to readily disclose such information on their web sites or with promotional material.

Sixth, while Congress took steps several years ago to require the disclosure of after-tax returns, the SEC does not require inclusion of this information in sales and promotional material unless a fund is claiming to be tax efficient. Investors wishing to know a fund's after-tax performance currently need to review the prospectus—something they should be doing, but generally are not. It may be appropriate to mandate broader use of after-tax performance data.

Recent Scandals

The SEC has had an active agenda addressing the specifics of "late trading," "market timing," and "breakpoint discounts." In particular, the SEC proposed a rule requiring that fund orders be received by 4 p.m. to address "late trading." To address "market timing" problems, the SEC proposed a rule requiring enhanced disclosures including: (1) "market timing" policies and procedures, (2) "fair valuation" practices, and (3) portfolio disclosure policies and procedures. Regarding "breakpoints," the SEC proposed enhanced disclosure regarding breakpoint discounts. In addition, the SEC adopted a rule on fund compliance policies and compliance officers and has proposed a rule on fund codes of ethics.

While the SEC has been able to move forward with these rules under the current authorities, Congress could include in any comprehensive reform package an endorsement or enhancement of these rules.

Conclusion

In conclusion, I believe that the recent mutual fund scandals have revealed the need for substantive reform regarding how mutual funds are governed and operated. Most importantly, it is the system of governance—whereby independent mutual fund directors act as gatekeepers for the benefit of investors—which deserves serious review and reconsideration.

Mutual funds now play a central role in America's capital markets. As we, as a Nation, face increasing global competition and prepare for the retirement of the baby-boom generation, I believe that we simply have no choice but to ensure that America has the fairest and most efficient capital markets in the world. Even small annual savings can lead to enormous differences upon retirement. Thus, mutual fund reforms, with the goal to promote greater retirement savings and lower the cost of capital, are ever more critical.

Thank you. I would be happy to answer any of your questions.

PREPARED STATEMENT OF JAMES K. GLASSMAN

RESIDENT FELLOW, AMERICAN ENTERPRISE INSTITUTE

FEBRUARY 25, 2004

Mr. Chairman and Members of the Committee, my name is James K. Glassman. I am a Resident Fellow at the American Enterprise Institute, where my focus is economic and financial issues. I am also host of the website *TechCentralStation.com,* which concentrates on matters of technology, finance, and public policy. In addition, for the past 10 years, I have written a weekly syndicated column for *The Washington Post* on investing. I have also written two books geared to small investors and have published numerous articles on investing topics in publications ranging from *The Reader's Digest* to *The Wall Street Journal.* Thank you for inviting me to testify at this important hearing on mutual funds from the point of view of the in-

vestor, especially the small investor, who is my main concern. I testify as an individual. The views are mine, not those of any institution with which I am connected.

The Mutual Fund Scandals

In early September of last year, the Attorney General of New York, Eliot Spitzer, announced that several mutual fund firms had allowed large investors to profit from practices that were either illegal or actively discouraged by their own published policies. One of those investors, Canary Capital Partners, LLC, a hedge fund, agreed to pay a fine of $40 million to settle civil charges. Since then, two dozen mutual fund houses, including several of the largest, have been implicated in the scandal, which, by the end of January, had led to civil or criminal complaints against at least 10 companies by attorneys general, the U.S. Securities and Exchange Commission, and the Justice Department; the dismissal or resignation of 60 executives, including the president of Alliance Capital and the CEO's of Pilgrim, Baxter & Associates, Putnam Investments, and Strong Capital; and the imposition of more than $640 million in penalties.[1]

Specifically, the charges concern two practices:

Late trading, by which an investor purchases shares in a mutual fund after the 4 p.m. deadline but pays the price at that day's close, rather than the next day's. This practice, which typically requires the collusion of a broker or mutual fund employee, is illegal.

Market timing, by which an investor makes quick trades in a mutual fund's shares. Most mutual funds discourage market timing—and so officially state to investors—because it can add costs for other shareholders in the fund.

Both practices attempt to capitalize on "stale prices"—usually in international stocks. Trading in Europe and Japan, for example, ends many hours before the 4 p.m. deadline and, in the interim, events may occur that could lift prices the next day. Through stale-price arbitrage, an investor can, to paraphrase Spitzer, bet on a horse after the outcome of the race is known.

These practices dilute the holdings of the other shareholders in the fund. According to research by Eric W. Zitzewitz, "In 2001, a shareholder in the average international fund in my sample lost 1.1 percent of assets to stale-price arbitrage trading and 0.05 percent of assets to late trading. Losses are smaller, but still economically significant, in funds holding small-cap equities or illiquid bonds."[2] Large-cap U.S. stock funds are generally unaffected.

The scandal is by far the most extensive to afflict the mutual fund industry, which, since its founding 80 years ago,[3] has been relatively free of impropriety and broadly respected by investors. Even before Eliot Spitzer filed his initial charges, however, the Congress and the SEC had been examining major changes in the structure and regulation of mutual funds, and, after the scandals, a flood of legislation was introduced, including three major bills in the Senate in the space of 20 days in November.[4]

But is the rush to regulate the proper response to the scandals? Judging from the perspective of the investor, as this hearing requests, I have serious doubts.

While steps need to be taken to ensure that some investors do not exploit stale pricing at the expense of others, the mutual fund industry is basically sound. It is highly decentralized and competitive, and, despite the scandals and the 3-year bear market in stocks, it continues to attract savings at a remarkable rate. The largest firms—including Fidelity Investments, which offers more than 300 funds; Vanguard Group, whose Index 500 Fund is the largest mutual fund with $77 billion in assets; and American Funds, which runs four of the top biggest funds, with assets totaling $200 billion—have not been tainted by the scandal.

A greater worry is that, by rushing to increase regulations in areas such as fees, board composition, and disclosure, policymakers run the risk of limiting choices and

[1] "Putnam Led Industry With $28.9 Billon of Withdrawals," Bloomberg, January 28, 2004.

[2] Eric W. Zitzewitz, Assistant Professor of Economics, Stanford University, testimony before the Subcommittee on Capital Markets, Insurance and Government-Sponsored Enterprises, Committee on Financial Services, U.S. House of Representatives, November 6, 2003.

[3] The Massachusetts Financial Services (MFS) is generally credited with launching the first mutual fund in the Spring of 1924. MFS, the eleventh largest mutual fund firm, reached an agreement on February 5, to pay $225 million and reduce fees in a settlement with regulatory authorities after charges of permitting market timing. In addition, the CEO and President of MFS have stepped down. (Letter to clients from Robert Manning of MFS, February 17, 2004, at *http://www.mfs.com/about/index.jhtml; $sessionid$5MJVUBMKDMDCBTXTQYUBFD4O4O DCSESS.)*

[4] S. 1822, S. 1958, and S. 1971. These three, along with H.R. 2420, passed by the House on November 19, 2003, are examined at length in a CRS Report (RL32157), "Mutual Fund Reform Bills: A Side-by-Side Comparison," updated December 9, 2003.

raising costs for small investors. The mutual fund industry is a great American success story. It has democratized finance. It has both provided capital for businesses and increased the net worth of families. But weighed down by dozens of new counterproductive rules, it could lose its robust character.

Popularity of Mutual Funds

The most striking characteristic of mutual funds is how popular they have become in such a short time. In a free economy with abundant selections, people buy what they want, and their investment of choice in the past three decades has been mutual funds. In 1970, for example, there were 361 funds with a total of $48 billion in assets. At the end of 2003, there were 8,124 funds with $7.2 trillion in assets. Mutual funds are owned by 91 million investors in 53 million U.S. households—roughly half the Nation.[5]

Even in the wake of the scandals, Americans have continued to invest in mutual funds. In 2003, a total of $152 billion in net new money (after redemptions) flowed into stock mutual funds, including $30 billion in November and December, at the height of the revelations by Spitzer and the SEC.

In his history of popular finance in America, Joseph Nocera, Editorial Director of *Fortune* magazine, wrote:

> Mutual funds became the investment vehicle of the middle class because they . . . struck people as making a good deal of sense. If anything, mutual funds made more sense than ever after the crash [of October 19, 1987, when the Dow Jones Industrial Average lost 22 percent of its value in one day]. For one thing, even the most aggressive mutual funds outperformed the market on Black Monday, and in so doing provided at least a little comfort to small investors. More importantly, as the financial life of the middle class became ever more complicated, connected irrevocably to such arcane as the state of the Japanese market and the shape of the yield curve, Americans took increasing solace in the central notion behind mutual funds—that by putting money in a fund, they were hiring a professional to make market decisions they felt increasingly incapable of making themselves.[6]

Mutual funds created a revolution in investing by providing average Americans with the same professional management and financial reporting enjoyed by the rich—and at roughly the same cost. Because of private research institutions like Morningstar Mutual Funds, investors can easily compare the performance and the fees of thousands of funds. Nocera quotes Don Phillips of Morningstar as saying, "One of the hidden advantages of the fund industry is that by packaging investments in consumer wrapping, mutual funds tap into the consumption skills baby boomers have spent their lifetimes refining. . . . Funds make investing very much like shopping."[7]

One of the many problems with proposals for mutual fund reforms is that the shopping will become much more difficult—with a profusion of new requirements that will mainly serve to confuse investors and add costs that will be borne by fund shareholders or taxpayers. The SEC alone has approved or is considering 17 separate rules changes[8] and these are in addition to those that may be enacted by other regulators or through legislation.

A better approach is to increase incentives of investors to discipline funds through their own choices—and to increase incentives of funds to communicate forcefully and clearly to investors and of Government to educate.

Investor Discipline is Harsh

The discipline of investors is far more harsh than anything regulators can dream up. Consider the new inflows and outflows of new money into major mutual funds during 2003[9]:

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[5] *2003 Mutual Fund Factbook,* 43rd edition, Investment Company Institute, May 2003; updated information from the ICI website, *www.ici.org.*

[6] Joseph Nocera, *A Piece of the Action: How the Middle Class Joined the Money Class,* Simon & Schuster, 1994, p. 369.

[7] *Ibid.*

[8] "Taking a Closer Look: The SEC's Fund To-Do List," Ian McDonald, *The Wall Street Journal Online,* January 14, 2004, at *http://online.wsj.com.*

[9] "Putnam Led Industry," Bloomberg, January 28, 2004, *op. cit.,* and "American Funds Get Highest Inflows in United States, Report Says," Bloomberg, January 29, 2004. Both articles use the Financial Research Corporation of Boston as their main source for data in the table that I have compiled.

Fund Company	Allegations of Impropriety?	Net Inflow or (Outflow)
		In billions of dollars
American	No	66
Vanguard	No	36
Fidelity	No	31
Putnam	Yes	(29)
Janus Capital	Yes	(15)
Amvescap (Invesco)	Yes	(8)
Alliance Capital	Yes	(2)

Putnam, for example, charges an annual expense ratio of between 1 percent and 1.55 percent for its equity funds, in addition to a 5.25 percent load, or up-front fee.[10] Imagine that Putnam merely loses 1 percent on the foregone assets each year. Based on an asset decline of $29 billion in 2003, that's a loss of $290 million in revenues—with much of it dropping straight to the bottom line—in the first year alone. Assume that a typical client who redeems her shares would have kept an account for 5 years; the total loss (assuming no more new redemptions in subsequent years but growth in assets of about 8 percent annually) is well over $2 billion.

The business of mutual funds is asset-gathering. Investors are willing to entrust their money to fund companies for many reasons: High historic returns, low expenses, good service, and confidence in the fund's integrity and safety.

When confidence is shaken—as it has been in the cases of Putnam, Janus, Amvescap (specifically, its subsidiary Invesco Funds Group, which is accused of allowing favored clients to make short-term trades), and Alliance—investors take appropriate action. They were encouraged in that action by analysts and commentators, including me.[11]

Instead of adding rules, policymakers could perform a more useful service by using the bully pulpit to condemn executives and firms who abuse their clients' trust and to laud those that act responsibly. That would encourage investors themselves to take action. Such statements should be part of a strategic program of investor education. There are other steps as well that would enhance competition and give mutual funds stronger incentives to communicate vigorously with the public.

Response and Recommendations

Let me now comment on specific recommendations and offer some of my own.

Late Trading

A rule that would require a hard 4 p.m. market close on all trading activity, including reconciling trades from financial intermediaries, would hurt small investors. It would, in practical terms, require small investors to make decisions to buy or sell shares in a fund well before the 4 p.m. close—without knowledge of late-day market events. The change "would require deadlines several hours earlier [than 4 p.m.] at intermediaries such as brokerage firms and 401(k) plans. Thus participants would have less flexibility."[12] Large professional investors, which either trade securities directly themselves or place their orders directly with fund companies, would have an advantage over small investors. The rule should state that all orders must be placed by buyers and sellers before 4 p.m. and time-stamped accordingly, with the understanding that the execution of those orders may not occur until after that

[10] These figures and all others regarding the individual expense ratios, loads and returns of mutual funds come from Morningstar Mutual Funds, at *www.morningstar.com.*

[11] "Don't Panic, But Start Selling," James K. Glassman, *The Washington Post,* November 9, 2003. I wrote, "It's time to dump Putnam, Strong, and Alger funds, unless you have a very good reason to keep them, such as avoiding a big tax bill or wanting to hold on to a fund that has been a superb performer. . . . In my view, it is reckless to entrust your money to institutions that have proved rotten at the top, no matter what their intentions for the future." Morningstar's more sweeping admonition to investors preceded mine and was certainly more influential.

[12] "Mutual Funds Vow to Fix Their Clocks," Karen Damato and Tom Lauricella, *The Wall Street Journal,* October 31, 2003.

time. A stronger national clearinghouse should be responsible for verifying the orders were placed before the closing time.

Fund companies have been chastened. Further illegal late-trading activity is unlikely, considering the high costs already imposed on the miscreants. At any rate, regulators should hold funds responsible for late trading in their funds, no matter who participates in the practice. Fidelity Investments has properly called the shortened deadline an overly simplistic approach that "ends up hurting the shareholders, not helping." [13] A new rule is not needed. Proper compliance with the current rule is needed.

Market Timing

If a fund states in its prospectus and other written materials that it discourages market timing, then it must adhere to that policy for all investors, large and small. But funds should be free to adopt policies that allow, or even encourage, short-term trading. The choice should be that of the fund itself, but it must be clearly communicated to investors.

Why do funds allow market timing in the first place? In order to gain more assets, which in turn can lower costs for the fund and its smaller shareholders. As D. Bruce Johnsen, Professor of Law at George Mason University, put it:

> According to the SEC's own findings, large accounts contribute far more than the average to scale economies in management. It is therefore no surprise that the SEC's perplexing rules prohibiting lower fees for larger accounts would lead fund advisers to compete for hedge fund dollars by tolerating large-scale internal timing. It is by no means clear that this reflects a breach of trust. Quite the contrary, fund advisers may have done nothing worse than cut loss-minimizing deals with hedge funds. By allowing the adviser to keep hedge fund money in the complex, all investors are likely to be better off compared to the alternative.[14]

Funds should be free to charge investors different fees according to the size of their investments, and the scheme for such pricing should be left to the mutual fund itself. Discriminatory pricing helps, rather than hurts, small investors, since it draws more large investors into the fund to share the costs.

The SEC is also expected to propose a mandatory fee of at least 2 percent on shares that investors sell within days or even weeks of purchase. Unfortunately, this rule, like the hard 4 p.m. deadline, has been endorsed by the Investment Company Institute, the mutual fund trade group.[15] This misguided rule will merely penalize small investors who need to move their funds in an emergency—or some other valid reason, such as poor performance by a fund or the revelations that the fund has been engaged in unsavory ethical practices.

It is perfectly valid for a fund to charge a high exit fee in an effort to keep shareholders invested—thus avoiding pressure on the fund manager to sell stock at importune times in order to raise cash. But, again, the choice must be that of the fund management itself. Investors, in turn, can choose whether they want to own a fund with a high redemption fee (perhaps adding stability to the fund's holdings) or a low or nonexistent redemption fee (to give the investors themselves some flexibility).

By mandating the high redemption fee, the SEC would be dampening competition among funds and providing all of them with serendipitous income in case of emergency withdrawals. A bad idea.

Independent Directors

The proposals have been advanced that would require each fund to have an independent chairman and for funds to increase the proportion of their independent directors from a majority to at least 75 percent. The reasoning here is that directors without an ownership stake or other financial interest will protect shareholders' interests. That may or may not be true. Enron Corporation had 11 independent directors (out of 15), but they failed to stop fraud and misrepresentation.[16]

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[13] Robert Reynolds, Chief Operating Officer of Fidelity, quoted in "Mutual Funds Vow to Fix Their Clocks," *op. cit.*

[14] "An Economic Defense of Mutual Fund Timing," D. Bruce Johnsen, unpublished paper presented as a draft at a conference at the American Enterprise Institute on January 28, 2004, titled, "Mutual Fund Regulation and Litigation: Is the Cure Worse Than the Disease?"

[15] "Mutual Funds Vow to Fix Their Clocks," *op. cit.*

[16] A Senate subcommittee found, "The Enron Board of Directors failed to safeguard Enron shareholders and contributed to the collapse of the seventh largest public company in the United States." ("The Role of the Board of Directors in Enron's Collapse," a report prepared by the Permanent Subcommittee on Investigations of the Committee on Governmental Affairs, U.S.

Continued

Mark Hulbert, Editor of *The Hulbert Financial Digest,* the respected scorekeeper for financial newsletters, wrote in *The New York Times,* "Almost all of the several dozen academic studies on board independence have found [either] that it has no correlation with company performance or that companies generally perform worse when they have more outsiders on their boards."[17] Why worse? Probably because the directors with a direct personal stake in a firm put more time and effort into governance.

Requirements like this one present a moral hazard problem for investors. Regulators are sending the signal: "We will require lots of independent directors on mutual funds, so investors won't have to worry about good corporate governance." In fact, investors should worry, and, if they do, mutual fund companies will have an enormous incentive to reassure them. Perhaps having lots of independent directors provides that assurance. If it does, the funds will advertise the fact. That is the proper dynamic to ensure integrity.

Disclosure and Fees

It is hard to be against disclosure, but the absurd amount of detail that the SEC is now requiring—and is proposing to require—may do more harm than good. Most disclosure involves expenses. My experience with readers is that their main interest in choosing a mutual fund is not the expenses, but the return. Ask any investor, and you will get the same answer: He would rather pay $100 in expenses to get a net return of $300 then pay $2 in expenses to get a net return of $299. In this judgment, small investors in mutual funds are no different from sophisticated investors in hedge funds. A typical hedge fund charges a 1 percent annual fee plus 20 percent of the profits. That can amount to far more than a mutual fund investor pays. In a year when the market is up 30 percent, a hedge fund investor pays about 7 percent in expenses, compared with an average of about 1.5 percent for a mutual fund investor.

The problem for all investors, however, is that past performance is no guarantee (or, in most cases, even indication) of future performance. Since markets tend to be efficient, most funds, over time, will produce returns that are close to those of the market as a whole, reflected, for example, by the Standard & Poor's 500 Stock Index. If funds tend to perform alike, then the fund with the lowest expenses will produce the highest net returns.

Life isn't quite so simple. Last year, for example, the top quartile of diversified stock mutual funds produced returns that averaged about 10 percentage points higher than the average fund, and there are gifted fund managers whose long-term records seem to show they have the ability to beat the market with some consistency. Still, expenses count, and it is difficult to get investors to believe that fact.

Despite the urging of practically every writer on the subject, despite the clear statement of fees at the start of every mutual fund prospectus, despite the detail on expenses in every Morningstar write-up, despite the industry's outreach,[18] despite the fact that about three-quarters of fund purchases are made through advisors whom investors can simply ask about fees, and despite the SEC's own excellent online fee calculator,[19] many—perhaps most—investors don't even know the fees that their funds charge. Since expenses are netted out of returns (that is, investors do not have to hand over a check for a fund's services), they are largely invisible.

Will more disclosures help? I doubt it. "Mutual fund fees are subject to more exacting regulatory standards and disclosure requirements than any comparable financial product offered to investors," says the Investment Company Institute, which is obviously an interested party but which is speaking here with accuracy.

Beyond the basics that are required today and are explained at length in the prospectus and "Statement of Additional Information" and are summarized by services like Morningstar, disclosure—in its extent and presentation—should be left to the funds themselves. They know how to communicate best with consumers. The job of the regulators is to ensure that the disclosure is accurate and that companies do what they say they will do. Companies and individuals that commit fraud should be vigorously prosecuted, as they have been—appropriately—in recent cases involving late trading and market timing.

Senate, July 8, 2002.) The chairmen of Enron's executive committee, finance committee, audit committee, and compensation committee were all independent (and, by any conventional observation, distinguished) independent directors.

[17] "Outside Directors Don't Mean Outside Returns," Mark Hulbert, *The New York Times,* June 15, 2003.

[18] For example, "Frequently Asked Questions About Mutual Fund Fees," booklet, Investment Company Institute, 2003.

[19] At *www.sec.gov/mfcc/mfcc-int.htm*

Funds already have an incentive to advertise low fees, just as grocery stores have an incentive to advertise low prices on bananas. The paucity of such advertising indicates that investors don't care about fees as much as they care, for example, about returns, and no amount of disclosure will change that fact. Additional disclosures will simply cause additional confusion and may lead policymakers to think they have done their job. One mutual fund CEO told me that only two people, out of the many thousands that are shareholders in his fund, request the Statement of Additional Information annually, and the CEO assumes that the two are "competitors rather than investors."

The SEC is also considering a requirement to disclose "incentives and conflicts that broker-dealers have in offering mutual fund shares to investors."[20] Disclosure would come through a confirmation form. I have examined this form and find it so complicated as to be unusable. It includes a complete page, in dense type, of "explanations and definitions," and it requires "comparison ranges," but it is unclear what is being compared with what: Small-cap funds, all funds, equity funds? The SEC should drop the disclosure approach and instead adopt an education approach (following).

Structure

Much of the confusion and problems related to mutual fund governance can be traced back to 1940, when a law established the industry's current legal structure, characterized recently by *Business Week* as an "antiquated set-up,"[21] and that is putting it mildly. Under the law, each mutual fund (and there are more than 8,000 today) is a separate company, "but it's essentially a shell, with directors but no employees. The fund board contracts out for all key services, from stockpicking to recordkeeping. In theory, the board can choose any adviser, but in reality, a fund company usually sets up a fund, appoints a board, and the board then hires the management company that founded the fund."[22]

It is doubtful that many investors understand this structure. They believe that the fund adviser owns the fund. The way to rationalize and modernize the current system is to treat mutual funds as investment products instead of companies. "It might make sense to permit funds to structure themselves the way people actually think of them—as services bought based on performance and cost," says Steven M.H. Wallman, a former SEC Commissioner who now runs the investment firm FOLIOfn.[23] The board that runs the funds, then, would be the board of the asset management company that is now the funds' adviser.

Competition Enhancement

Rather than adding rules, policymakers should seek ways to enhance competition. Already, the mutual fund industry is fiercely competitive—and getting more so. The five largest fund houses accounted for just 33 percent of mutual fund assets in 2002, down from 37 percent in 1990. The 10 largest fund houses accounted for 46 percent of assets, down from 56 percent in 1990. With 4,700 equity mutual funds, investors have vast choices.[24] Some funds charge commissions, or loads, at the time of purchase; others at the time of sale. Others impose no loads at all, instead getting all their investor income from annual fees, charged as a percentage of total assets.

The most popular mutual fund, Vanguard Index 500, carries no load and charges just 18 basis points in annual expenses. The second largest, Fidelity Magellan, also imposes no load and charges only 76 basis points. There are abundant low-cost choices.

"The actual costs borne by average stock mutual fund shareholders have dropped 45 percent since 1980," said Brian Reid, Deputy Chief Economist for the Investment Company Institute, reporting on a recent study by Peter Tufano of Harvard and Erik Sirri of Babson College. The study found that 60 percent of shareholder assets are invested in funds with total expense ratios under 1 percent.[25] An extensive study of fees found a decline in the weighted-average annual expense ratio for stock mutual funds from 2.26 percent in 1980 to 1.28 percent in 2001; for bond funds,

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[20] Testimony of William H. Donaldson, Chairman of the SEC, before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, September 30, 2003, at *www.sec.gov/news/testimony/ts093003whd.htm.*

[21] "Funds Need a Radical New Design," Amy Borrus and Paula Dwyer, *Business Week,* November 17, 2003, p. 47.

[22] *Ibid.*

[23] *Ibid.*

[24] These figures and subsequent industry are from the *2003 Mutual Fund Factbook.*

[25] "ICI Economist Reports that 'Total Shareholder Cost' of Investing in Stock Mutual Funds Has Declined 45 Percent Since 1980," Press Release, Investment Company Institute, February 18, 2004.

from 1.53 percent in 1980 to 0.9 percent in 2001.[26] Fidelity recently did away with its 3 percent loads on sector funds. Fees don't fall, of course, because fund company executives are nice guys. They fall because costs drop through economies of scale and, more important, because competition puts pressure on prices.

Investors do not, however, opt for low costs alone. Nor should they. They consider financial returns and service as well. PIMCO Total Return, a bond fund, has accumulated $74 billion in assets despite a 4.5 percent front load plus annual expenses of 0.9 percent. The reason is simply that the fund's manager, Bill Gross, has compiled such a spectacular record in recent years. Similarly, Legg Mason Value Trust, with a lofty expense ratio of 1.72 percent, has increased its assets from less than $1 billion in 1993 to $14 billion today largely because its manager, William Miller, has beaten the benchmark Standard & Poor's 500 Stock Index in each of those years (plus two more), an astounding record.

Last December, two top Republicans on the House Financial Services issued a Press Release stating, "All mutual fund shareholders deserve lower fees. Not just shareholders who invested in funds that engaged in questionable trading practices; not just shareholders invested in one fund family; but all mutual fund shareholders deserve relief from fees that continue to rise."[27] First, it appears that fees are not rising; but, second, in a competitive market, with few supply constraints, higher fees (if they did arise) would be a reflection of higher demand. The concept that any consumer "deserves" a particular price is an artifact of poor economic thinking. Efforts to push down costs by Government fiat or intimidation (an approach of Spitzer) are misguided and misinformed. It is competition that holds down prices.

A good way to enhance competition and get the lower fees that some policymakers seek is to increase the supply of funds—that is, the choices of investors.[28] But adding new regulations—even disclosure requirements that appear innocuous—will have the opposite effect. Some funds will simply not be able to afford the added legal, accounting, research and publishing costs. They will either close down, merge, or boost expenses beyond the reach of small investors.

An attraction of mutual funds is that they offer small investors much the same professional services that well-off investors have enjoyed for years. Recently in New Orleans, I visited the firm St. Denis J. Villere & Co., founded in 1911 to manage the money of institutions and wealthy investors—a task it has performed exceptionally well. Villere requires a minimum starting account of $500,000 for its advisory clients. In 1999, after requests from smaller investors, the firm launched a public mutual fund, Villere Balanced, which requires an initial investment of just $2,000. The fund, which combines stocks and bonds, has been an exceptional performer, beating the S&P by an annual average of 7 percentage points over the past 3 years. But it remains small: Just $17 million in assets.

Such a fund—and there are many—will bear a heavy burden if the regulatory wish list goes into effect. More important, small investors could lose choices like Villere Balanced. Calamos Growth, by some accounts the top diversified stock fund in America, had only $12 million in assets in 1998 and now has $5 billion. It won those assets through impressive performance (returning an annual average of 21 percent for the past 5 years), but, with heavy regulatory expenses, it might have been killed in the cradle. By the way, Calamos charges a front load of 4.75 percent and annual expenses of 1.4 percent. Is that too much? Evidently not for the investors who have piled into the fund to benefit from the talents of the Calamos family, who last year produced returns of 42 percent of their shareholders.

Another way to enhance competition—and improve the governance of funds—is by making it easier for investors to exit funds that have failed to meet financial or ethical expectations. A major obstacle to redemption of fund shares is the capital gains tax. Investors are reluctant to leave a fund they have held for a long time if they have to pay Federal taxes of 15 percent on their profits.

Mr. Bruce R. Bent, who invented the money-market fund in 1972, proposes that "investors be permitted to sell shares of a mutual fund for any reason . . . without incurring tax, provided that the proceeds are reinvested in a similar fund . . . within 30 days."[29] In this rollover plan, Bent would require investors who sell shares

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[26] "Frequently Asked Questions," *op. cit.,* p. 13.

[27] "Oxley, Baker: All Mutual Fund Investors Deserve Lower Fees," Press Release, House Committee on Financial Services, December 17, 2003. The Press Release is quoted in my article, "Spitzer vs. the SEC," James K. Glassman, *TechCentralStation.com,* December 19, 2003 *(http://www.techcentralstation.com/121903G.html),* which contains a discussion of the competitive nature of the mutual fund industry.

[28] Another way to lower expenses would be to decrease the demand for funds, which would best be accomplished if funds did not perform a service that consumers wanted. In other words, if funds would only do a worse job, prices would fall.

[29] Bruce R. Bent, private correspondence, January 30, 2004.

in a small-cap fund, for example, to buy shares in another small-cap fund. This seems to me needlessly complicated; I would allow purchases of shares in any fund, or in individual stocks and bonds, for that matter. But either way, Bent has the right approach. Public policy should be directed at intensifying competition and increasing the anxiety of funds that, if they betray their customers, they will lose a great deal of business.

Investor Education

As boring as it may sound, the most important step that policymakers can take to improve governance of mutual funds and to help small investors is to focus on investor education. Today, lip service is paid and a small amount of money is spent. Far more effort is required, and it needs to be centralized. The SEC, the Treasury Department, and the Labor Department all have investor education programs. Instead, there should be a single office, with sufficient funding and dynamic, marketing-oriented leadership.

Let me close on a disturbing paper by Ali Hortacsu and Chad Syverson.[30] The two University of Chicago economists looked at 85 retail index funds geared to the S&P 500 (an index fund is constructed to mimic the performance of a popular stock or bond index; the S&P 500 is the most popular such index, in part because it reflects about 85 percent of the total U.S. stock market capitalization in only 500 stocks). The number of S&P index funds has quintupled since 1992, so, clearly, investors have wide choices.

What is disturbing is that "the highest price S&P 500 index fund in 2000 imposed annualized investor fees nearly 30 times as great as those of the lowest-cost fund: 268 vs. 9.5 basis points" (a basis point is one one-hundredth of a percentage point, so 268 bp equals 2.68 percent). The authors continue, "This striking divergence is not restricted to the far ends of the distribution; the seventy-fifth/twenty-fifth and ninetieth/tenth percentile price ratios are 3.1 and 8.2, respectively."[31]

The authors ask, "How can so many firms, charging such diffuse prices, operate in a sector where funds are financially homogeneous?"[32] In other words, why do funds that return the same (that is, they all pretty much return, before expenses, what the S&P 500 returns) charge fees that are so different?

The principal answer they give is that there has been an "influx of high-information-cost novice investors."[33] Very simply, many investors are unsure about the investments they are purchasing. The costs—that is, the value of the time spent—in investigating the expenses of one index fund over another are so high that these investors just pick a name they know, or rely on the suggestions of friends or advisors. "While average search costs were declining, costs for those at the upper percentiles of the distribution actually tended to increase through our sample years."[34] Again, to translate: Most investors have learned a great deal over the years about investing, so the costs to them of picking a fund are falling, but costs (again, in time) are still high for new investors.

This study shows, with glaring illumination, just how much education is needed, especially for novices. Not disclosure, not new rules, not onerous requirements, but simple education. Much of that education has been provided by mutual fund companies themselves and, of course, by journalists and research firms. But more education is urgently required, and here the Government has a significant role to play.

Thank you.

[30] "Product Differentiation, Search Costs, and Competition in the Mutual Fund Industry: A Case Study of S&P 500 Index Funds," October 2003.
[31] *Ibid,* pp. 2–3.
[32] *Ibid.,* p. 3.
[33] *Ibid.,* frontispiece.
[34] *Ibid.,* p. 32.

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HEADLINE: STRATEGIES;
Outside Directors Don't Mean Outsize Returns

BYLINE: By MARK HULBERT; Mark Hulbert is editor of The Hulbert Financial Digest, a service of CBS MarketWatch. His column on investment strategies appears every other week. E-mail: mailto:strategy@nytimes.com.

BODY:

RESEARCHERS have found little evidence that companies improve their performance by raising the number of independent directors on their boards. In fact, some recent studies have found that they perform worse — a result that would surprise many corporate reformers.

Independent directors are neither employees nor officers of the company, and they have no business or personal relationships with it. Many advocates of change say that outsiders are in a better position than insiders to resist unwise corporate policies, and that increasing the number of independent directors should improve performance.

That has not worked out in practice, however. Almost all of the several dozen academic studies on board independence have found that it has no correlation with company performance or that companies generally perform worse when they have more outsiders on their boards.

A widely cited academic study was begun in the mid-1990's by Sanjai Bhagat, a finance professor at the University of Colorado at Boulder, and Bernard Black, now a law professor at Stanford. Examining nearly 1,000 publicly traded American companies, the professors found that from the end of 1990 through 1993, the companies that performed the worst were those whose boards had the greatest proportion of outside directors when the period began. The study was published in the winter 2002 issue of the Journal of Corporation Law.

The professors measured corporate performance in several ways, including stock returns, return on assets and the ratio of sales to assets. They also calculated the ratio of a company's market capitalization to the replacement cost of its assets — known as Tobin's Q ratio, for the late James Tobin, the 1981 Nobel laureate in economics; the professors consider that ratio to be a good proxy for investor confidence in a company's management.

The researchers said their findings did not necessarily mean that greater board independence caused poor performance. In fact, the reverse may be true: companies that are performing particularly poorly often increase the number of outside directors in the hope of restoring investor confidence. The companies' subsequent performance might not show improvement because the outside directors did not counteract the policies that had led to poor performance in the first place.

The research on board independence contrasts with other studies that have found that good corporate governance is associated with better performance. One of the most comprehensive of such studies, which appeared in the February 2003 issue of the Quarterly Journal of Economics, was conducted by Paul A. Gompers, a professor of business administration at the Harvard Business School; Joy Ishii, a graduate student in economics at Harvard; and Andrew Metrick, a finance professor at the Wharton School of the University of Pennsylvania.

They focused on 24 different ways in which companies restrict shareholder rights — for example, through so-called poison pill defenses, which aim to immunize corporate leadership from a hostile takeover. The researchers found that during the 1990's, companies with the fewest restrictions significantly outperformed companies with the most restrictions.

Though Professor Gompers and his co-authors did not focus on boards' independence, he sees no contradiction among the various studies. One of the most crucial factors in a company's long-term performance, he said, is its corporate culture: Is the firm responsive to shareholder concerns, or has it immunized itself from any such influence? "Directors have had little effect on corporate performance," Professor Gompers said, "because they largely have been unwilling to change that culture."

He said he believes that "until and unless boards become more active, board independence will continue to be a poor proxy for good corporate culture."

URL: http://www.nytimes.com

GRAPHIC: Graph: "Overrated Independence?"A study published in 2002 of nearly 1,000 large companies found that those with the fewest outsiders on their boards performed better than those with the most outsiders. Valuation Jan. 1, 1991 - Dec. 31, 1993As measured by Tobin's Q ratio of a company's market capitalization to the replacement value of its assets. A higher ratio indicates more investor confidence in management. Fewest outside board members: 1.14Most outside board members: 0.97 (Sources: Sanjai Bhagat University of Colorado at Boulder and Bernard Black Stanford)

The Non-Correlation Between Board Independence and Long-Term Firm Performance

Sanjai Bhagat* and Bernard Black**

ABSTRACT

The boards of directors of American public companies are dominated by independent directors. Many commentators and institutional investors believe that a "monitoring board," composed almost entirely of independent directors, is an important component of good corporate governance. The empirical evidence reported in this Article challenges that conventional wisdom.

We conduct the first large-sample, long-horizon study of whether the degree of board independence (proxied by the fraction of independent directors minus the fraction of inside directors on a company's board) correlates with various measures of the long-term performance of large American firms. We find evidence that low-profitability firms increase the independence of their boards of directors. But there is no evidence that this strategy works. Firms with more independent boards do not perform better than other firms. Our results support efforts by firms to experiment with board structures that depart from the conventional monitoring board.

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** Professor of Law, Stanford Law School. Research support was provided by the Q Group and the Institutional Investor Project at Columbia Law School. We thank Institutional Shareholder Services for making its director database available to us. We also thank George Benston, James Brickley, Gerald Davis, John Donohue, Jeff Gordon, Milton Handler, David Ikenberry, Sherry Jarrell, Ehud Kamar, Stacey Kole, April Klein, Bevis Longstreth, Anil Shivdasani, Randall Thomas, David Yermack, Marc Zenner, anonymous referees, and participants in workshops at the Atlanta Finance Forum, American Finance Association, Columbia Law School, Georgetown Law School, NYU Center for Law and Business, Rice University, University of Rochester (Simon School of Business), and Stanford Law School, for their comments. We thank Renee Johnson, Robert King, Ann Le, Karen Lutz, Michelle Ontiveros, Michael Reyes, Mark Rysman, Sapna Sanagavarapu, Yan Yang, and Helen Yu for research assistance.

I. INTRODUCTION

Over the last thirty years, American corporate boards have undergone a gradual but dramatic change. In the 1960s, most had a majority of inside directors. Today, almost all have a majority (usually a large majority) of outside directors, most have a majority (often a large majority) of independent directors, and an increasing number have only one or two inside directors. This pattern reflects the conventional wisdom that the board's principal task is to monitor management, and only independent directors can be effective monitors. In contrast, an insider-dominated board is seen as a device for management entrenchment.[1] For example, guidelines adopted by the Council of Institutional Investors call for at least 2/3 of a company's directors to be independent; guidelines adopted by the California Public Employees Retirement System and by the National Association of Corporate Directors call for boards to have a "substantial majority" of independent directors.[2] American corporate governance experts and institutional investors are now

1. *See, e.g.*, MELVIN A. EISENBERG, THE STRUCTURE OF THE CORPORATION: A LEGAL ANALYSIS (1976); William B. Chandler III, *On the Instructiveness of Insiders, Independents, and Institutional Investors*, 67 U. CIN. L. REV. 1083, 1084 (1999) (describing the "conventional wisdom" in exactly these terms); Ira M. Millstein, *The Evolution of the Certifying Board*, 48 BUS. LAW. 1485 (1993); AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 3A.01 (1994).

2. COUNCIL OF INSTITUTIONAL INVESTORS, SHAREHOLDER BILL OF RIGHTS (1998); CALIFORNIA PUBLIC

exporting this conventional wisdom around the world. It has only an occasional dissenting voice.[3] Even the Business Roundtable (an organization of large-firm CEOs), which once opposed proposals for more independent boards, now recommends that boards have a "substantial majority" of independent directors.[4] Yet there are numerous anecdotes where a highly independent board hasn't prevented large-scale wealth destruction. Enron (with eleven independent directors on its fourteen-member board) is only the most recent example. When we turn from anecdote to quantitative evidence, the conventional wisdom favoring highly independent boards lacks a solid empirical foundation, in this or other studies.

We study in this Article three related questions. First, does greater board independence produce better corporate performance, as conventional wisdom predicts? Second, and conversely, does board composition respond to firm performance? Third, does board size predict firm performance? Prior quantitative research on the first two questions has been inconclusive; for the third, two studies report that firms with large boards perform worse than firms with smaller boards. We report here evidence from the first large-scale, long-time-horizon study of the relationship among board independence, board size, and the long-term performance of large American firms. We study measures of financial performance and growth from 1985-1995 for 934 of the largest United States firms, using data on these firms' boards of directors in early 1991 and board data for a random subsample of 205 firms from early 1988.

Our principal findings: We find evidence that low-profitability firms respond to their business troubles by following conventional wisdom and increasing the proportion of independent directors on their boards. There is no evidence, however, that this strategy works. Firms with more independent boards (proxied by the fraction of independent directors minus the fraction of inside directors) do not achieve improved profitability, and there are hints in our data that they perform worse than other firms. This evidence suggests that the conventional wisdom on the importance of board independence lacks empirical support. Board size also shows no consistent correlation with firm performance, though we find hints of the negative correlation found in other studies.

We conduct a number of robustness checks on our results. Our results on the noncorrelation between board independence and performance persist: (i) after controlling for board size, firm size, industry effects, CEO stock ownership, stock ownership by outside directors, and number and size of outside 5% blockholders; (ii) in both an ordinary least squares and a simultaneous equations framework; (iii) when we run

EMPLOYEES RETIREMENT SYSTEM, CORPORATE GOVERNANCE CORE PRINCIPLES AND GUIDELINES (1998), *at* http://www.calpers-governance.org/principles/domestic/us/page01.asp; NATIONAL ASSOCIATION OF CORPORATE DIRECTORS, REPORT OF THE NACD BLUE RIBBON COMMISSION ON DIRECTOR PROFESSIONALISM 12 (2001).

3. For examples of these dissents, see Bevis Longstreth, *Corporate Governance: There's Danger in New Orthodoxies*, CORP. GOVERNANCE ADVISOR, July/August 1994, at 18-21; James M. Tobin, *The Squeeze on Directors—Inside is Out*, 49 BUS. LAW. 1707 (1994).

4. BUSINESS ROUNDTABLE, STATEMENT ON CORPORATE GOVERNANCE 10 (1997), *at* http://www.brtable.org/pdf/11.pdf. For the Business Roundtable's earlier views, see generally STATEMENT OF THE BUSINESS ROUNDTABLE ON THE AMERICAN LAW INSTITUTE'S PROPOSED PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS (1983) [hereinafter BUSINESS ROUNDTABLE (1983)].

Koenker-Bassett robust regressions, which give less weight to outlying observations;[5] (iv) for regressions that use dummy variables for different ranges of board independence or otherwise allow for a nonlinear relationship between board independence and firm performance; and (v) in regressions that include separate independent variables for the proportion of independent directors and the proportion of inside directors.

If our results are correct, the current focus on board independence as a core measure of board quality could detract from other, perhaps more effective strategies for addressing poor firm performance. At the least, corporate governance advisors and institutional investors should support efforts by firms to experiment with different board structures and be more tentative in their advice that other countries should adopt American-style monitoring boards.

We do not doubt that independent directors are important. No one else can effectively restrain insider self-dealing or fire the CEO when necessary. Indeed, one of us has stressed, in other recent work, the role of independent directors in controlling self-dealing.[6] The policy question raised by our results is whether inside and affiliated directors also play valuable roles that may be lost in a single-minded drive for greater board independence.

This Article is organized as follows. Part II briefly reviews the literature on the relationship between firm performance and board composition and between firm performance and board size. Part III describes our research design and sample characteristics. Part IV contains our principal results on the correlation and direction of apparent causation between board independence and firm performance, and the correlation between board size and performance. Part V explores the relationship between firm growth rates and board independence. Part VI develops possible explanations for our results and offers some policy conclusions.

II. PRIOR RESEARCH ON BOARD COMPOSITION

A. Does Board Composition Affect Firm Performance?

Two recent articles, one written by us, survey the literature on how board composition affects firm performance or vice versa. Thus, our discussion of prior research is brief and emphasizes recent research not covered in these surveys.[7] Studies of the effect of board composition on firm performance generally adopt one of two approaches. The first approach involves studying how board composition affects the board's behavior on discrete tasks, such as replacing the CEO, awarding golden parachutes to executives, acquiring another firm, or defending against a takeover bid. The second approach directly examines the relationship between board composition and firm performance.

5. *See* Roger Koenker & Gilbert Bassett, Jr., *Regression Quantiles*, 46 ECONOMETRICA 33 (1978).

6. Bernard S. Black, *The Legal and Institutional Preconditions for Strong Securities Markets*, 48 UCLA L. REV. 781, 810 (2001).

7. *See* Sanjai Bhagat & Bernard Black, *The Uncertain Relationship Between Board Composition and Firm Performance*, 54 BUS. LAW. 921 (1999); Michael S. Weisbach & Benjamin E. Hermalin, *Boards of Directors as an Endogeneously Determined Institution: A Survey of the Economic Literature* (working paper 2000), *at* http://papers.ssrn.com/abstract=233111 (Social Science Research Network).

Board behavior on discrete tasks. The first approach to studying boards of directors focuses on particular board tasks. This approach can involve tractable data, which makes it easier for researchers to find statistically significant results. But it doesn't tell us how board composition affects overall firm performance. For example, there is evidence that firms with majority-independent boards perform more effectively than other boards on particular tasks, such as replacing the CEO[8] and making takeover bids.[9] However, there are other monitoring tasks where differences based on board independence have been hypothesized but not found, including gains from divestitures and the likelihood that management will commit illegal acts.[10] On still other tasks, there is little evidence of effective monitoring. For example, there is evidence that CEO compensation correlates positively with the compensation of the outside directors from their own firms, and only negligibly with the CEO's performance.[11]

Moreover, even if majority-independent boards perform better than other boards on some tasks, they could perform worse on other tasks for which inside directors may be valuable, but which cannot readily be studied using this approach (such as selecting a new CEO or choosing a new strategic direction for the firm). If so, firms might realize no net gain in overall performance from having majority-independent boards.

Furthermore, even if firms perform better on some tasks when they have a majority of independent directors, it is not clear that having a *supermajority* (substantially more than 50%) of independent directors will further improve board performance. Most studies do not address this question. Some report differences between majority-independent and non-majority-independent boards, while others report differences between firms with at least 60% independent directors and other firms. No study asks whether there are behavior differences between, for instance, a board with six independent directors out of nine (67%), and a board with seven out of nine (78%) or eight out of nine (88%) independent directors. Yet current conventional wisdom calls for supermajority-independent boards, with only one or two inside directors on a typical nine or eleven member board.

Overall correlation between board composition and firm performance. The second approach to studying boards of directors, and the approach adopted in this Article, involves studying whether board composition affects overall firm performance. This approach allows us to examine the "bottom line" of firm performance (unlike the first approach), but involves much less tractable data. Firm performance must be measured

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8. *See* Michael S. Weisbach, *Outside Directors and CEO Turnover*, 20 J. FIN. ECON. 431 (1988).

9. *See* John W. Byrd & Kent A. Hickman, *Do Outside Directors Monitor Managers?: Evidence from Tender Offer Bids*, 32 J. FIN. ECON. 195 (1992) (noting higher bidder returns if firms have majority-independent boards). *But see* V. Subrahmanyam, N. Rangan & S. Rosenstein, *The Role of Outside Directors in Bank Acquisitions*, FIN. MGMT., Autumn 1997, at 23 (finding the opposite result for banks that acquire other banks).

10. *See, e.g.*, Robert C. Hanson & Moon H. Song, *Managerial Ownership, Board Structure, and the Division of Gains in Divestitures*, 6 J. CORP. FIN. 55 (2000) (finding no general correlation between fraction of independent directors and divestiture gains, but also an odd (to our eyes) correlation conditioned on the buyer and seller realizing joint gains); Idalene F. Kesner, Bart Victor & Bruce T. Lamont, *Board Composition and the Commission of Illegal Acts: An Investigation of Fortune 500 Companies*, 4 ACAD. MGMT. J. 789 (1986).

11. *See* Charles A. O'Reilly III, Brian G. Main & Graef S. Crystal, *CEO Compensation as Tournament and Social Comparison: A Tale of Two Theories*, 33 ADMIN. SCI. Q. 257 (1988).

over a long period, which means that performance measures are noisy and perhaps misspecified.[12]

Prior research does not support a clear correlation between board independence and firm performance. For example, early work by Vance reports a positive correlation between the proportion of *inside* directors and a number of performance measures.[13] Baysinger and Butler,[14] Hermalin and Weisbach,[15] and MacAvoy and coauthors[16] all report no significant same-year correlation between board composition and various measures of corporate performance. A recent large-sample study by Ferris and his coauthors finds no significant correlation between proportion of outside directors in 1995 and ratio of market value to book value in 1997.[17] An early exception to these nonresults comes from Baysinger and Butler, who report that the proportion of independent directors in 1970 correlates with *1980* industry-adjusted return on equity.[18] However, their ten-year lag period is very long for any effects of board composition on performance to persist. Studies in Australia, Singapore, and the United Kingdom also find no correlation between board composition and firm performance.[19]

A few studies offer hints that firms with a high percentage of independent directors may perform *worse*. Yermack reports a significant negative correlation between the proportion of independent directors and contemporaneous Tobin's q,[20] but no significant correlation for several other performance variables (sales/assets; operating income/assets; operating income/sales).[21] Agrawal and Knoeber report a negative correlation between

12. On the specification of stock price returns over long periods, see S.P. Kothari & Jerold B. Warner, *Measuring Long-Horizon Security Price Performance*, 43 J. FIN. ECON. 301 (1997); Brad M. Barber & John D. Lyon, *Detecting Long-Run Abnormal Stock Returns: The Empirical Power and Specification of Test Statistics*, 43 J. FIN. ECON. 341 (1997); Brad M. Barber & John D. Lyon, *Detecting Abnormal Operating Performance: The Empirical Power and Specification of Test Statistics*, 41 J. FIN. ECON. 359 (1996).

13. *See* STANLEY C. VANCE, BOARD OF DIRECTORS: STRUCTURE AND PERFORMANCE (1964).

14. *See* Barry Baysinger & Henry Butler, *Corporate Governance and the Board of Directors: Performance Effects of Changes in Board Composition*, 1 J. L. ECON. & ORG. 101 (1985).

15. *See* Benjamin E. Hermalin & Michael S. Weisbach, *The Effect of Board Composition and Direct Incentives on Firm Performance*, FIN. MGMT, Winter 1991, at 101.

16. *See* Paul W. MacAvoy et al., *ALI Proposals for Increased Control of the Corporation by the Board of Directors: An Economic Analysis*, *in* BUSINESS ROUNDTABLE (1983), *supra* note 4, at exh. C-1.

17. *See* Stephen P. Ferris, Murali Jagannathan & A.C. Pritchard, *Too Busy to Mind the Business? Monitoring by Directors with Multiple Board Appointments* (working paper 2002), *earlier version available at* http:/papers.ssrn.com/abstract=167288 (Social Science Research Network). Other U.S. studies finding no significant results include Hamid Mehran, *Executive Compensation Structure, Ownership and Firm Performance*, 38 J. FIN. ECON. 163 (1995).

18. *See* Baysinger & Butler (1985), *supra* note 14, at 115-18.

19. *See* Mara Faccio & M. Ameziane Lasfer, *Managerial Ownership, Board Structure and Firm Value: The UK Evidence* (working paper 1999), *at* http://papers.ssrn.com/abstract=179008 (Social Science Research Network); Jeffrey Lawrence & G.P. Stapledon, *Is Board Composition Important? A Study of Listed Australian* Companies (working paper 1999), *at* http://papers.ssrn.com/abstract=193528 (Social Science Research Network); Y.T. Mak & Yuan Li, *Determinants of Corporate Ownership and Board Structure: Evidence from Singapore*, 7 J. CORP. FIN. 235 (2001).

20. Tobin's q is the ratio of the market value of a firm's assets to the book value of its assets. It is often approximated by the ratio of the market value of a firm's long-term debt and equity to the book value of its long term debt and equity. Tobin's q is used as a measure of good management because high Tobin's q suggests that a firm's managers have produced greater market value from the same assets.

21. *See* David Yermack, *Higher Market Valuation of Companies with a Small Board of Directors*, 40 J. FIN. ECON. 185 (1996).

the proportion of outside directors and Tobin's q.[22] Klein reports a significant negative correlation between a measure of change in market value of equity and proportion of independent directors, but insignificant results for return on assets and stock market returns.[23] Fosberg reports that majority-outside boards have a significantly lower sales/assets ratio, but finds insignificant (although generally negative) results for several other performance measures.[24]

Event studies. Rosenstein and Wyatt find that stock prices increase by about 0.2%, on average, when a company appoints an additional outside director.[25] This increase, while statistically significant, is economically small and could reflect signaling effects. Appointing an additional outside director could signal that a company plans to address its business problems, even if board composition doesn't affect the company's ability to address these problems. Moreover, Rosenstein and Wyatt find a stronger price reaction for outside directors who work for financial institutions than for directors whose principal job is with another unrelated non-financial corporation.[26] Yet outside directors who work for financial institutions are usually treated as affiliated outside directors rather than independent directors, because their own firm may be interested in business dealings with the firm on whose board they sit.Rosenstein and Wyatt find that stock prices neither increase nor decrease on average when an *insider* is added to the board.[27]

Composition of board committees. Klein finds that *inside* director representation on a board's investment committee correlates with improved firm performance. She finds little evidence that the "monitoring" committees that are usually dominated by independent directors—the audit, compensation, and nominating committees—affect performance, regardless of how they are staffed.[28]

B. Does Firm Performance Affect Board Composition?

An important issue in studying the correlation between board composition and firm performance is the direction of causation. Board composition could affect firm performance, but firm performance can also cause the firm to change its board composition. Prior researchers have found limited evidence of an endogenous relationship between firm performance and board composition, in which performance affects board composition. (We discuss in Part III.E other possible sources of an endogenous relationship among board composition, firm performance, and other firm characteristics.)

22. *See* Anup Agrawal & Charles R. Knoeber, *Firm Performance and Mechanisms to Control Agency Problems Between Managers and Shareholders*, 31 J. FIN. & QUANTITATIVE ANALYSIS 377 (1996).

23. *See* April Klein, *Firm Performance and Board Committee Structure*, 41 J.L. & ECON. 275, 286-88 (1998).

24. *See* Richard H. Fosberg, *Outside Directors and Managerial Monitoring*, AKRON BUS. & ECON. REV., Summer 1989, at 24.

25. *See* Stuart Rosenstein & Jeffrey G. Wyatt, *Outside Directors, Board Independence, and Shareholder Wealth*, 26 J. FIN. ECON. 175 (1990).

26. *Id.* at 188-90.

27. *See* Stuart Rosenstein & Jeffrey G. Wyatt, *Inside Directors, Board Independence, and Shareholder Wealth*, 44 J. FIN. ECON. 229, 239 (1997).

28. *See* Klein (1998), *supra* note 23, at 293-96.

Hermalin and Weisbach, and Weisbach (using the same data set), report that the proportion of independent directors on large firm boards increases when a company has performed poorly. This effect is statistically significant but numerically small. Firms in the bottom performance decile in year *X* (measured using either earnings changes or stock price changes) increase their proportion of independent directors by less than 1% in year *X*+1, relative to other firms, from 1972 through 1983.[29] Weisbach concludes from this evidence that "[s]ince the change in board composition following poor performance is relatively small, and board composition changes very slowly over time, it is unlikely that the potential endogeneity of the board composition is a serious problem."[30]

In contrast to Hermalin and Weisbach, Klein finds no evidence that performance affects board composition. In her sample, firms in the bottom quintile for 1991 stock price returns are no more likely to add independent directors in 1992 and 1993 than firms in the top quintile.[31] Denis and Sarin report that firms that substantially increase their proportion of independent directors had *above-average* stock price returns in the previous year. They also report that average board composition for a group of firms changes slowly over time and that board composition tends to regress to the mean, with firms that have a high (low) proportion of independent directors reducing (increasing) this percentage over time.[32]

C. The Unsolved Puzzle: Why Has Board Composition Changed So Radically?

The weak, equivocal data on the overall connection between board independence and firm performance leaves an unsolved puzzle. The composition of public company boards of directors has changed radically over the last thirty years. Until around 1970, insiders numerically dominated boards of directors. For example, Baysinger and Butler found 54% inside directors, 26% affiliated directors, and only 20% independent directors in a sample of 266 large firms in 1970. By 1980, the proportion of inside directors in their sample had dropped to 43% and the proportion of independent directors had risen to 31%.[33] Similarly, Hermalin and Weisbach, using a narrower definition of affiliated directors, found that firms had 49% inside directors, 13% affiliated directors, and 38% independent directors in 1971. By 1983, inside directors had fallen to 34% and independent directors had grown to 54%.

The trend toward greater board independence has continued. In our 1991 sample, the median firm has an eleven member board with three inside directors, one affiliated director, and seven independent directors. In percentages, the median firm had 23% inside directors, 13% affiliated directors, and 64% independent directors (see Table 1 below). By 1997, the mean number of inside directors at S&P 500 firms (which should be comparable to our sample) had dropped from three to two, and 56% of the S&P 500 firms had only one or two inside directors.[34]

29. Benjamin E. Hermalin & Michael S. Weisbach, *The Determinants of Board Composition*, 19 RAND J. ECON. 589 (1988); Weisbach (1988), *supra* note 8, at 454.

30. Weisbach (1988), *supra* note 8, at 454.

31. *See* Klein (1998), *supra* note 23, at 292.

32. *See* David J. Denis & Atulya Sarin, *Ownership and Board Structures in Publicly Traded Corporations*, 52 J. FIN. ECON. 187 (1999).

33. *See* Baysinger & Butler (1985), *supra* note 14, at 113.

34. *See* Bhagat & Black (1999), *supra* note 7, at 922; SPENCERSTUART, 1997 BOARD INDEX: BOARD TRENDS AND PRACTICES AT S&P 500 CORPORATIONS (1997).

At any point in time, different firms have different board structures. Those differences can predict performance, respond endogenously to performance or other firm characteristics, or both. Interfirm differences in board independence may reflect departures from efficiency, but they could also be an efficient response to differences in firm characteristics. Even if interfirm variation in board composition is partly endogenous, however, the large multidecade shift in board composition makes it hard to explain board composition entirely as an efficient, endogenous response to economic pressures that push firms to choose efficient governance structures. It is simply not apparent why (hypothetically) a majority-inside board was efficient up to around 1970, a roughly 50% independent board was efficient in the 1980s, and a supermajority-independent board is efficient today.

More plausibly, the large long-term shift in board structures responds to changes in conventional wisdom and perhaps also to legal pressures. The Delaware Supreme Court, for example, has long encouraged majority-independent boards by giving greater deference to decisions by these boards.[35] If the shift in board composition responds to external pressure, then it may be neither efficient nor an endogenous response to firm characteristics.

Given the equivocal data and the importance that conventional wisdom attaches to highly independent boards, a closer look at whether greater board independence predicts improved firm performance, using more recent data, a larger sample (to improve signal to noise ratio), and a long time horizon (because the effects of composition on performance may appear only over time) seems warranted. We undertake that study here.

III. RESEARCH DESIGN AND SAMPLE CHARACTERISTICS

We follow the common practice of dividing directors into *inside directors* (persons who are currently officers of the company), *affiliated directors* (relatives of officers; persons who are likely to have business relationships with the company, such as investment bankers and lawyers; and persons who were officers in the recent past) (sometimes called *gray directors*) and *independent directors* (outside directors without such affiliations).[36]

We indicate the proportions of independent and inside directors as f_{indep} and f_{inside}, respectively. Prior studies have generally used f_{indep} as the board composition variable of interest. This treats inside and affiliated directors as equally (non)independent, when in fact, affiliated directors may often be substantially independent. We instead measure

35. *See, e.g.*, Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985) (stating that judicial deference to board's decision to oppose a takeover is "materially enhanced" when the board has a majority of independent directors). Idalene F. Kesner & Roy B. Johnson, *An Investigation of the Relationship Between Board Composition and Stockholder Suits*, 11 STRATEGIC MGMT. J. 327 (1990), confirm that firms with a higher proportion of inside directors are subject to more shareholder lawsuits.

36. See the definitions in INSTITUTIONAL SHAREHOLDER SERVICES, THE ISS PROXY VOTING MANUAL 3.7-3.9 (3d ed., rev. 2001) and Council of Institutional Investors, *at* http://app.cii.org/glossary.cfm. Our categories of "independent director," "affiliated director," and "inside director" correspond to the "outside director," "gray director," and "inside director" categories used by other authors. *See* Baysinger & Butler (1985), *supra* note 14; MacAvoy et al. (1983), *supra* note 16; Weisbach (1988), *supra* note 8; at 435-36.

board independence as $INDEP = f_{\text{indep}} - f_{\text{inside}}$. This effectively treats independent, affiliated, and inside directors as having independence weights of +1, 0, and -1, respectively.[37]

A. Procedure for Data Collection and Analysis

This study seeks to measure the correlation between board independence and firm performance, and also the correlation between board size and firm performance, while correcting weaknesses (especially limited sample size, short measurement period, and limited control variables) in prior studies that may explain why these studies generally do not find significant results. We focus primarily on the relationship between board independence and firm performance, but return in Part IV.G to the effects of board size on firm performance.

We use both an ordinary least squares and a simultaneous equations (three stage least squares) approach to assess whether board composition affects firm performance, firm performance affects board composition, or both. We use data on board composition in early 1991 from a database compiled by Institutional Shareholder Services (ISS) of 957 large U.S. public corporations, including virtually all of the largest American firms. ISS classified each director, at each firm, as inside, independent, or affiliated. We exclude from this database twenty-three firms without stock price data available from the Center for Research in Security Prices (CRSP), to produce a "1991 sample" of 934 firms. To test the robustness of our results, we also collect data on board composition in early 1988 for a randomly chosen subsample of 205 firms using proxy statements obtained from LEXIS/NEXIS.

We supplement this board data with: data from Compustat on the sample firms' accounting performance between 1985 and 1995 (available for 928 firms for at least some variables and some years); data from CRSP on the sample firms' stock price performance during this period; and data on share ownership obtained from proxy statements (available for 780 firms). We collect the following information on holdings of voting shares (to the nearest 0.1%):[38]

- the chief executive officer's (CEO's) percentage ownership;[39]

37. As a robustness check on our results, we reran most of the regressions reported in this Article using f_{indep} and f_{inside} as separate independent variables. Both variables were only intermittently significant.

38. Any share ownership study faces difficulty handling stock options and firms with two or more classes of voting stock. Our decision rules were as follows: SEC rules require ownership disclosure for options that are exercisable currently or within sixty days. We include these options in computing share ownership. When two classes of voting stock have identical or nearly identical *economic* interests but different voting rights (typically two classes of common stock), we compute share ownership as the percentage of total outstanding shares of both classes. This percentage *economic interest* will differ from percentage *voting interest*. If two classes have different economic interests (most commonly when a firm has voting convertible preferred stock), we use voting power as a proxy for economic interest, and compute ownership interest based on the percentage of total votes for shares of both classes.

It can be frustrating and sometimes impossible to determine from proxy statements a family group's total share ownership when the family's shares are held by multiple trusts with overlapping trustees. We treat such family groups as a single shareholder, doing our best to compute total ownership. We treat the family group as an outside shareholder if no person with that family name is a company officer.

39. Where a firm has nonstandard titles, or separates the titles of CEO and Chairman, it can be difficult to determine who is the real chief executive officer. If a firm has a CEO and a Chairman who are different people, we treat the named CEO as the chief executive officer if the named Chairman is an outsider with another

- the percentage ownership by all directors and officers;
- the percentage ownership by all outside directors (for 1988, by all independent directors) (these two measures are highly correlated);
- the number of outside shareholders or shareholder groups that own 5% or more of the company's voting shares; and
- the total percentage ownership by all outside 5% shareholders.

We expect board composition to affect performance only gradually. We therefore cumulate performance data over a multiyear period surrounding the date(s) when we measure board composition. Below, when we use board composition and stock ownership data from early 1991, we report regression results for performance measures for the "retrospective" period from 1988-1990 (preceding the board composition measurement date) and for the "prospective" period from 1991-1993 (following the board composition measurement date). We also compute, but do not report, results for the earlier retrospective period of 1985-1987 and the later prospective period of 1994-1995; these results are similar to those for the closer-in-time periods that we report. When we use board composition and stock ownership data from early 1988 (for our 1988 subsample), we treat 1985-1987 as the retrospective period and 1988-1990 as the prospective period.

B. Tests for Entry and Exit Bias

This study, like any study of long-term performance, could produce biased results due to entry into and exit from the sample over time. For the retrospective period, firms that were included in our sample in early 1991, but not in earlier years, may have a different relationship between board independence and performance than firms that appear in the sample for the entire period. Similarly, firms that drop out of the sample during the prospective period may have a different relationship between board independence and performance than firms that survive for this period of time.

However, entry and exit bias does not appear to be a significant concern for our sample. With regard to exit during the prospective period, we find no significant correlation between board composition or board size and the probability that a firm exits the sample between 1991 and 1995:

Spearman Correlation Coefficients
(two-tailed significance levels in parentheses; sample size = 815)

	Proportion of Inside Directors	**Proportion of Independent Directors**	**Board Size**
Probability that Firm, Included in Sample In 1991, Survives Through 1995	-.008 (.817)	.034 (.303)	.025 (.464)

primary job, and treat the named Chairman as the chief executive officer if he appears to be an executive of the company without another primary job.

Also, for the 1985-1987, 1988-1990, and 1991-1993 periods, we measure the correlation between firm performance and board composition with board composition measured at two different times, early 1988 and early 1991, and obtain similar results. This suggests that entry bias is not significant because the full 1991 sample includes, while the 1988 subsample excludes, firms that enter the full sample between 1988 and 1991.

C. Performance Variables

There is no single ideal measure of long-term firm performance. We collect data on four measures of firm performance, each with support in the accounting and finance literature as a respectable measure of firm performance.

Description	**Variable Name**
Tobin's q[40]	*Q*
Return on assets (ratio of operating income to assets)	*OPI/AST*
Ratio of sales to assets	*SAL/AST*
Market adjusted stock price returns[41]	*MAR*

The accounting variables are chosen to be independent of a firm's capital structure (ratio of debt to total capital) and its tax position. We obtain similar results with a number of other performance variables, including sales per employee, operating margin (operating income/sales), and a cash flow measure (cash flow/assets).

Stock price returns must be used with caution as a performance measure because they are susceptible to investor anticipation. If investors anticipate the effects of board composition on performance, long-term stock returns will be insignificant, even if a significant correlation between performance and board independence in fact exists. For this reason, we rely mostly on Tobin's q *(Q)*, ratio of operating income to assets *(OPI/AST)*, and ratio of sales to assets *(SAL/AST)* as our performance measures. In the Appendix we present selected results using market adjusted stock price returns as the performance measure. The results using stock price returns are consistent with the results for other variables.

40. We compute Tobin's q for a particular year as q = (market value of common stock + book value of preferred stock + book value of long-term debt)/(book value of total assets), with all values measured at year-end. Other measures of Tobin's q are possible, but Chung and Pruitt report a very high correlation between relatively careful and relatively crude measures. *See* Kee H. Chung & Stephen W. Pruitt, *A Simple Approximation of Tobin's q*, FIN. MGMT., Autumn 1994, at 70. More sophisticated measures also require additional data, which leads to missing observations and can cause sample selection bias. *See* Darrell E. Lee & James G. Tompkins, *A Modified Version of the Lewellen and Badrinath Measure of Tobin's Q*, FIN. MGMT., Spring 1999, at 20.

41. We use a simple measure of stock returns, *market-adjusted return (MAR)*, measured by cumulating over the measurement period daily returns minus the return on the S&P 500 index, *without* an adjustment for beta. For the multi-year periods over which we cumulate returns, Kothari & Warner report that MAR is better specified than abnormal return measures that include a beta adjustment. *See* Kothari & Warner (1997), *supra* note 12. In separate regressions (not shown), we confirm for our sample that MAR is better specified than measures based on cumulative abnormal returns or standardized abnormal returns.

D. Control Variables

Our regression results control for a number of factors that could affect firm performance, board composition, or both. The control variables that we use are:

- board size;
- CEO ownership (percent);
- outside director ownership (percent);
- firm size, proxied by log(sales);[42]
- number of outside 5% blockholders;[43]
- industry control—we classify firms into 302 industry groups based on 4-digit SIC codes, omitting industries for which Compustat has data on only one or two firms in that 4-digit industry;[44] and
- a constant term (not shown in the regressions).

E. Endogeneity

Board composition could affect future firm performance, but a firm's need for a particular board structure, the firm's past performance, and other factors could also affect the firm's future board composition.[45] The factors that influence board composition are not well understood. As we noted in Part II.C, the large changes in the composition of typical boards over the last several decades suggest that board composition is also affected by conventional wisdom, legal rules, and other external pressures that likely relate only weakly to firm characteristics.

Inter-industry differences in percentage of independent directors, at any one point in time, are relatively modest. This suggests that endogeneity that reflects industry-specific characteristics is limited. Agrawal and Knoeber report, for a sample of large firms in 1987, that the proportion of outside directors in eleven broad industry groups varied only from 66% in textiles to 77% in instruments, with a mean of 72%.[46] Moreover, some industry differences could reflect factors, other than industry, which influence the

42. For the performance variable with sales in the numerator *(SAL/AST)*, we use log(assets) instead of log(sales) to control for firm size. We also run regressions (not reported) using log(assets) instead of log(sales) as the size control for *Q* and *OPI/AST*. The results are similar to the regressions with log(sales) that we report in the text. For regressions using 1991 (1988) board composition and stock ownership data, we measure firm size at year-end 1990 (1987) for assets, and in 1990 (1987) for sales.

43. We also run regressions (not reported) using percentage holdings of all outside 5% blockholders as an additional control variable. This variable is generally insignificant. The coefficients for the number of outside 5% blockholders decline because the number of outside 5% blockholders and percentage holdings of all outside 5% blockholders are highly correlated (Spearman correlation coefficient = .909). The coefficients for other variables are virtually unchanged.

44. The control variable for each regression is the mean value for the industry of the performance variable that is used as a dependent variable in that regression. We also run regressions using 2-digit SIC code industry groups, and using four broad "1-digit" industry groups as a dependent variable: utility (SIC codes 4800-4999), financial (SIC codes 6000-6999), transportation (SIC codes 3700-3799, 4000-4581, 4700-4799), and industrial (all other SIC codes). The results with 2-digit industries are similar to those that we report in the text. The results with 1-digit industry groups are similar except as noted in the text.

45. For a general discussion of endogeneity in board composition studies, see Weisbach & Hermalin (2000), *supra* note 7.

46. *See* Anup Agrawal & Charles R. Knoeber, *Do Some Outside Directors Play a Political Role?*, 44 J.L. & ECON. 179, 182 (2001).

proportion of outside directors. For example, smaller firms have a higher proportion of inside directors, and the textile industry is composed of relatively small firms. There is also evidence that some firms choose some directors for their political connections,[47] that board composition is related to a firm's ownership structure (firms with high inside ownership have less independent boards),[48] and that firms with powerful CEOs have less independent boards.[49]

If board composition is endogenous, ordinary least squares (OLS) coefficient estimates can be biased. Simultaneous equations methods can address endogeneity, but are often more sensitive than OLS to model misspecification.[50] We address the combination of endogeneity and uncertainty about which econometric model to use partly by using an extensive set of control variables and robustness checks, and also by running both OLS and three-stage least squares (3SLS) regressions. Our OLS and 3SLS coefficient estimates and *t*-statistics for the effect of board independence on firm performance are similar, which suggests that endogeneity and model misspecification are not seriously skewing our results.[51]

F. Sample Characteristics

Table 1 provides summary statistics for the composition of the boards of directors of our sample firms. The median firm has an eleven member board, with seven independent directors, three inside directors, one affiliated director, and *INDEP* = .40. The variable *δINDEP* is the change in *INDEP* between 1991 and 1988.

47. *See id.* at 187-91.

48. *See infra* Part III.F.

49. For a theoretical model, see Benjamin E. Hermalin & Michael S. Weisbach, *Endogenously Chosen Boards of Directors and Their Monitoring of the CEO*, 88 AM. ECON. REV. 96 (1998). For empirical evidence, see N. Arthur, *Board Composition as the Outcome of an Internal Bargaining Process: Empirical Evidence*, 7 J. CORP. FIN. 307 (2001); April Klein, CEO Power, Board Independence and CEO Compensation (2000) (working paper, New York University, Stern School of Business); Anil Shivdasani & David Yermack, *CEO Involvement in the Selection of New Board Members: An Empirical Analysis*, 54 J. FIN. 1829 (1999).

50. *See* Scott W. Barnhart & Stuart Rosenstein, *Board Composition, Managerial Ownership, and Firm Performance: An Empirical Analysis*, 33 FIN. REV. 1 (1998).

51. We also reran selected tables using Koenker-Bassett robust regressions, which give less weight to outlying observations rerun for both dependent and independent variables. *See* Koenker & Bassett (1978), *supra* note 5. These regressions (not reported) show only minor variations in coefficients and *t*-statistics from the results reported in the text. Thus, our results are not significantly affected by outlying observations.

Table 1
Sample Characteristics: Board of Directors

Summary statistics for the board composition of the 934 large U.S. public companies included in the Institutional Shareholder Services director database for 1991 and for change in board independence from 1988 to 1991 *(δINDEP)*. Standard deviation is in parentheses.

				Percentiles				
Category	**Median**	**Mean (std. dev.)**	**Min.**	**10**	**20**	**80**	**90**	**Max.**
Inside Directors	3	2.84 (1.64)	0	1	2	4	5	14
Affiliated Directors	1	1.59 (1.52)	0	0	0	3	3	9
Independent Directors	7	7.03 (3.48)	0	3	4	9	11	22
Entire Board	11	11.45 (3.74)	4	7	8	14	16	30
Fraction: Inside Directors	.23	.26 (.14)	0	.10	.14	.38	.46	.83
Fraction: Affiliated Directors	.12	.14 (.13)	0	0	0	.25	.31	.75
Fraction: Independent Directors	.64	.60 (.19)	0	.18	.43	.75	.82	1.00
$INDEP = f_{indep} - f_{inside}$	.40	.33 (.31)	-1.00	-.11	.09	.58	.67	1.00
$\delta INDEP$	.00	-.02 (.22)	- .80	-.28	-.17	.16	.22	.67

As Table 1 shows, most large U.S. public companies have a high proportion of independent directors. The sample median (mean) of 64% (60%) independent directors can be compared with earlier studies, which generally show a smaller fraction of independent directors.[52] These studies are snapshots taken at different times during a long-term trend, discussed in Part II.C, toward greater board independence.

About 70% of the firms in our sample have majority-independent boards. About 85% have more independent than inside directors (*INDEP* > 0). Only 54 firms (5.8% of the sample) have majority-inside boards. Firms with majority-inside boards tend to be smaller and to have higher inside ownership than the other sample firms.[53] Table 2 reports summary statistics for our performance variables.

52. Our board composition results are similar to those of Klein (1998), *supra* note 23, at 275, who studies 485 large companies in 1991-1992, and finds a mean board size of 12.3, with 23% inside directors, 19% affiliated outside directors, and 58% independent directors. Klein finds a higher percentage of affiliated outside directors than we do because she treats interlocking directorships, where Company *A*'s CEO sits on Company *B*'s board, and vice-versa, as indicating affiliation, while we do not.

53. The fifty-four firms with majority-inside boards had mean (median) total assets of $3,981 million ($917 million) in 1993, compared to $9,002 million ($2,178 million) for the full sample, and mean (median) inside ownership of 21.1% (10.9%), compared to 9.0% (3.0%) for the full sample.

Table 2
Sample Characteristics: Performance Variables

Performance variables for 928 large U.S. public companies for 1985, 1990, and 1995. The variables *Q*, *OPI/AST* and *SAL/AST* are defined in Part III.C. *Q* 85 means Tobin's *q* for 1985, and similarly for other variables.

Variable	Median	Mean	Minimum	Maximum	Std. Deviation	Sample Size
Q 85	0.93	1.28	0.06	12.2	1.21	790
Q 90	0.88	1.18	0.03	8.4	1.1	898
Q 95	1.05	1.31	0.05	11.6	1.1	795
OPI/AST 85	.23	.25	-.17	.98	.13	651
OPI/AST 90	.21	.23	-.22	1.15	.11	764
OPI/AST 95	.20	.22	-.06	.99	.10	654
SAL/AST 85	.98	1.06	.01	6.28	.80	825
SAL/AST 90	.93	1.00	.07	5.62	.75	901
SAL/AST 95	.92	.97	.02	4.75	.69	797

Table 3 shows summary share ownership data for our sample. Board composition is related to inside share ownership. In our sample, the Spearman correlation coefficient between percentage of shares held by company officers and f_{inside} (f_{indep}) is .32 (-.41). Also, independent directors who own substantial blocks of stock may monitor more intensely than directors who own little stock. Similarly, monitoring by large outside blockholders could complement or substitute for monitoring by the board of directors. Thus, it important to control for stock ownership in assessing the relationship between board composition and firm performance.

Table 3
Sample Characteristics: Firm Ownership Structure

Stock ownership data for early 1991 for 780 large U.S. public companies (to nearest 0.1%). Standard deviation is in parentheses.

		Mean		Percentiles					Sample
Ownership Data	**Median**	**(std. dev.)**	**Min.**	**10**	**20**	**80**	**90**	**Max.**	**Size**
CEO ownership	0.5	3.8 (9.9)	0.0	0.0	0.1	3.0	9.7	84.2	779
Ownership by all directors and officers	3.0	9.0 (14.0)	0.0	0.3	0.8	4.5	27.2	85.1	780
Outside director ownership	1.0	2.8 (5.6)	0.0	0.1	0.2	3.2	6.5	71.1	768
No. of outside 5% blockholders (up to 5)	1.0	1.4 (1.3)	0	0	0	2	3	5	778
For firms with outside 5% blockholders:									
Ownership by all blockholders	17.8	21.9 (15.6)	5.0	6.4	8.3	31.7	43.2	96.9	520
Ownership of largest 5% blockholder	10.2	14.4 (11.9)	5.0	6.0	7.2	18.2	28.6	82.0	537
Ownership of 2d largest 5% blockholder	6.9	7.8 (3.3)	5.0	5.3	5.6	9.3	10.6	39.0	330
Ownership of 3d largest 5% blockholder	6.2	6.8 (1.9)	5.0	5.2	5.4	8.0	9.6	16.0	148
Ownership of 4th largest 5% blockholder	5.8	6.4 (1.9)	5.0	5.1	5.2	6.7	8.4	14.7	63
Ownership of 5th largest 5% blockholder	5.7	6.1 (1.3)	5.0	5.2	5.2	7.0	8.4	9.6	17

Table 4
OLS Estimates: Performance Variables on Board Independence and Ownership Structure

Ordinary least squares regression results for various performance variables on board independence and stock ownership for 928 large U.S. public companies for 1988-1990 and 1991-1993. The performance variables *Q*, *OPI/AST*, and *SAL/AST* are defined in Part III.C. *Q* 88-90 means average *Q* during 1988-1990 and similarly for other performance variables. Board and stock ownership variables are based on early 1991 data. Industry control for each regression is the mean of the dependent variable for that regression for each firm's industry group; 302 industry groups are constructed on the basis of 4-digit SIC codes from Compustat. Sample size varies from 552 to 684 because of missing data. *t*-statistics are in parentheses. Significant results ($p < .05$) are in **boldface** (not shown for firm size or industry control).

Dependent Variables	Independent Variables							Adj. R^2
	INDEP	Board size	CEO ownership	Outside director ownership	No. of Outside 5% Holders	Log (firm size)	Industry control	
Q 88-90	**-.44 (-4.98)**	-.001 (-.03)	.004 (1.59)	**.009 (2.13)**	**-.074 (-3.76)**	-.13 (-5.56)	.64 (14.79)	.376
Q 91-93	**-.22 (-2.09)**	-.018 (-1.81)	.003 (.79)	.007 (1.38)	**-.067 (-2.92)**	-.09 (-3.29)	.80 (18.92)	.429
OPI/AST 88-90	**-.07 (-4.87)**	**-.003 (-2.07)**	-.001 (-.91)	.001 (1.49)	-.003 (-.84)	.002 (.60)	.42 (9.49)	.187
OPI/AST 91-93	-.01 (-.88)	.001 (.06)	.001 (.68)	.001 (1.44)	-.005 (-1.61)	-.001 (-.34)	.71 (11.78)	.214
SAL/AST 88-90	**-.21 (-3.09)**	**-.020 (-2.64)**	**-.005 (-2.22)**	.005 (1.53)	.022 (1.42)	.08 (4.38)	.82 (26.5)	.588
SAL/AST 91-93	-.07 (-1.36)	**-.016 (-3.00)**	-.003 (-1.93)	.004 (1.64)	**.025 (2.18)**	.05 (3.55)	.89 (35.0)	.699

IV. FULL SAMPLE RESULTS (USING 1991 BOARD AND STOCK OWNERSHIP DATA)

A. OLS Results for Board Independence and Firm Performance

Table 4 presents our basic OLS results for the full 1991 sample.[54] During the retrospective period, board independence, proxied by *INDEP*, correlates significantly and *negatively* with all three performance measures. During the prospective period, the correlation remains negative for all variables, but is significant only for *Q*. These results are consistent with poor performance inducing firms to adopt more independent boards.

The results in Table 4 offer no evidence that firms with more independent boards perform better. They provide evidence instead that firms with more independent boards do *not* perform better, and hints that these firms suffer worse performance than other firms. Whatever reasons prompt poorly performing firms to increase board independence, this strategy does not improve their future performance.[55]

B. Simultaneous Equations Results for Board Independence and Firm Performance

We address the possible endogeneity of board independence and firm performance, suggested by the results in Table 4, by adopting a three stage least squares approach (3SLS), as described by Theil.[56] This procedure permits firm performance, board independence, and CEO ownership to be endogenously determined. For each endogenously determined variable, we need an instrumental variable—a variable that is correlated with the variable of interest, but is ideally (and in the 3SLS procedure, is assumed to be) uncorrelated with the error term. The endogenous variables and corresponding instrumental variables we use are:

54. When data is available for only some years in a multiyear measurement period, we compute the average for the period using the year(s) with available data. We use $p < .05$ (in a two-tailed test) as the threshold for statistical significance. Results with $.05 < p < .10$ are considered "marginally significant." Significant results are shown in **boldface**.

55. We perform a variety of checks for robustness, in addition to those described elsewhere in this Article. First, results are similar with two-digit industry controls. With one-digit industry controls, OPI/SAL 91-93 becomes significantly negative and OPI/AST 91-93 is negative and marginally significant. Second, we obtain similar results with a number of other performance variables, including sales per employee, operating margin (operating income/sales), and cash flow/assets. The coefficients on *INDEP* are negative and significant or marginally significant for 1988-1990, and generally negative but only sometimes significant for 1991-1993. Third, we obtain similar results in regressions where we replace *INDEP* ($= f_{indep} - f_{inside}$) with f_{inside} and f_{indep} (in direct or log form) as independent variables, except that the negative coefficient on *INDEP* is typically split between a negative coefficient on f_{indep} and a positive coefficient on f_{inside}. This is consistent with our judgment that *INDEP* is a better measure of board independence than f_{indep} alone.

56. *See* HENRI THEIL, PRINCIPLES OF ECONOMETRICS 508-23 (1971). 3SLS is a systems estimating procedure that estimates all the identified structural equations together as a set, instead of estimating the structural parameters of each equation separately as in the two stage least squares procedure (2SLS). The 3SLS procedure is a full information method that uses knowledge of all the restrictions in the entire system when estimating the structural parameters. The 3SLS estimator is consistent and in general is asymptotically more efficient than the 2SLS estimator. *See* W.M. Mikhail, *A Comparative Monte Carlo Study of the Properties of Economic Estimators*, 70 J. AM. STAT. ASS'N 94, 103 (1975).

- *firm performance measure*: normalized earnings per share (earnings per share divided by share price at the beginning of the measurement period);
- *board independence*: f_{indep}; and
- *CEO ownership*: share ownership by all directors and officers.

We estimate the following system of equations:

- *Equation 5.1: firm performance* = f_1 (*INDEP*, CEO ownership, board size, outside director ownership, no. of outside 5% holders, log(firm size), industry performance control)
- *Equation 5.2: INDEP* = f_2 (firm performance, CEO ownership, outside director ownership, no. of outside 5% holders, log(firm size))
- *Equation 5.3: CEO Ownership* = f_3 (firm performance, outside director ownership, log(firm size))

Our 3SLS results are shown in Panel *A* of Table 5, with our performance variables as the nominally dependent variables. These results are comparable to Table 4. The coefficients and *t*-statistics for board independence are virtually unchanged from Table 4. This increases our confidence in both the OLS and 3SLS results. We again find no evidence that firms with more independent boards perform better than other firms. Once again, we find hints that firms with more independent boards may perform worse.

Panel *B* strongly confirms the suggestion from the 1988-1990 data in Table 4 and in Panel *A* of a correlation between poorer firm performance in the recent past and greater board independence. This is consistent with firms responding to poor performance by increasing board independence. The coefficients on all three performance variables for 1988-1990 are negative and highly significant.

In Panel *A* of Table 5, we include regressions using performance variables for 1988-1990, and in Panel *B*, we include regressions using performance variables for 1991-1993. We include these regressions for parallelism with Table 4, but omit these regressions in subsequent 3SLS tables because they have no obvious causal interpretation in a simultaneous equations framework.

Table 5: Simultaneous Equations (3SLS) Instrumental Variables Estimates

Simultaneous equations (three stage least squares) regression results for various performance variables on board independence and stock ownership for 928 large U.S. public companies for 1988-1990 and 1991-1993. The instrumental variables and system of equations are defined in Part IV.B. The performance variables *Q, OPI/AST,* and *SAL/AST* are defined in Part III.C. *Q* 88-90 means average *Q* during 1988-1990 and similarly for other performance variables. Board and stock ownership variables are based on early 1991 data. Industry control for each regression in Panel *A* is the mean of the dependent variable for that regression for each firm's industry group; 302 industry groups are constructed on the basis of 4-digit SIC codes from Compustat. Sample size varies from 552 to 684 because of missing data. *t*-statistics are in parentheses. Significant results ($p < .05$) are in **boldface** (not shown for firm size or industry control).

Panel *A*: Equation 5.1 (Firm Performance as Dependent Variable)

Dependent Variable: Firm Performance	Independent Variables							Adj. R^2
	INDEP	Board Size	CEO Ownership	Outside Director Ownership	No. of Outside 5% Holders	Log (firm size)	Industry Control	
Q 88-90	**-.49 (-4.86)**	-.001 (-.06)	.005 (1.46)	**.009 (2.05)**	**-.07 (-3.51)**	-.12 (-5.29)	.65 (14.8)	.3777
Q 91-93	**-.28 (-2.29)**	-.02 (-1.72)	.002 (.54)	.007 (1.36)	**-.06 (-2.85)**	-.08 (-3.28)	.80 (18.8)	.4289
OPI/AST 88-90	**-.08 (-5.23)**	-.003 (-1.90)	-.001 (-.59)	.001 (1.32)	-.002 (-.86)	.002 (.53)	.45 (9.61)	.1978
OPI/AST 91-93	-.01 (-.74)	.001 (.12)	.001 (.77)	.001 (1.46)	-.005 (-1.57)	-.001 (-.29)	.71 (11.8)	.2165
SAL/AST 88-90	**-.21 (-2.66)**	**-.02 (-2.29)**	-.001 (-.34)	.005 (1.44)	.02 (1.56)	.08 (4.48)	.81 (26.1)	.5806
SAL/AST 91-93	-.09 (-1.46)	**-.01 (-2.77)**	-.001 (-.52)	.004 (1.57)	**.03 (2.36)**	.05 (3.72)	.89 (34.7)	.6975

Panel *B*: Equation 5.2 (Board Independence as Dependent Variable)

Dependent Variable	Independent Variables						Adj. R^2
	Firm Performance Measure	Firm Performance	CEO Ownership	Outside Director Ownership	No. of Outside 5% Holders	Log (firm size)	
INDEP	*Q* 88-90	**-.21 (-6.81)**	**-.01 (-6.80)**	-.0001 (-.03)	.009 (.90)	-.004 (-.40)	.203
	Q 91-93	**-.11 (-5.57)**	**-.01 (-7.91)**	-.001 (-.49)	.016 (1.80)	.001 (.10)	.179
	OPI/AST 88-90	**-2.42 (-8.70)**	**-.01 (-5.31)**	.002 (.69)	.015 (1.30)	.02 (1.48)	.198
	OPI/AST 91-93	**-.90 (-3.38)**	**-.01 (-6.88)**	-.001 (-.42)	.02 (1.97)	.02 (2.40)	.149
	SAL/AST 88-90	**-.13 (-6.23)**	**-.01 (-7.99)**	-.001 (-.16)	**.04 (4.64)**	.04 (4.39)	.198
	SAL/AST 91-93	**-.12 (-6.64)**	**-.01 (-8.41)**	-.001 (-.17)	**.04 (4.54)**	.03 (3.77)	.193

Panel *C*: Equation 5.3 (CEO Ownership)

Dependent Variable	Independent Variables				Adj. R^2
	Firm Performance Measure	Firm Performance	Outside Director Ownership	Log (firm size)	
CEO Ownership	*Q* 88-90	**4.13 (4.34)**	.04 (.63)	-.73 (-2.13)	.062
	Q 91-93	**2.44 (3.95)**	.03 (.46)	-.95 (-3.21)	.056
	OPI/AST 88-90	**28.3 (3.62)**	-.05 (-.62)	-1.40 (-4.43)	.056
	OPI/AST 91-93	**31.9 (3.83)**	-.08 (-.99)	-1.33 (-4.30)	.057
	SAL/AST 88-90	**1.41 (1.99)**	.04 (.61)	-1.50 (-5.09)	.0419
	SAL/AST 91-93	1.16 (1.93)	.03 (.51)	-1.39 (-5.15)	.0394

C. Does Growth or Growth Opportunity Affect Board Composition?

We check the robustness of the results in Tables 4 and 5 in various ways. First, we test for the possibility that a correlation between firm (or industry) growth rate or growth prospects and both firm profitability and board composition may be driving our results. To do so, we add the following additional control variables to equation 5.2:

- *GrSAL* 88-90 = fractional *firm* sales growth from 1987 to 1990 (as a measure of firm growth in the recent past);
- fractional *industry* sales growth from 1987 to 1990 (as a measure of the growth opportunities available in the industry in the recent past, even if not seized by this particular firm);
- *GrSAL* 91-93 = fractional *firm* sales growth from 1990 to 1993 (as a measure of the future growth opportunities available to the firm, because realized future growth is a proxy for current growth opportunities); and
- fractional *industry* sales growth from 1990 to 1993 (as a measure of the future growth opportunities available in the industry, even if not seized by this particular firm).

Our system of simultaneous equations then becomes:

- *Equations 6.1 and 6.3:* same as equations 5.1 and 5.3, respectively
- *Equation 6.2: INDEP* = f_2 (firm performance, CEO ownership, outside director ownership, number of outside 5% holders, log(firm size), *GrSAL* 88-90, industry sales growth from 1987 to 1990, *GrSAL* 91-93, industry sales growth from 1990 to 1993)

Our results are shown in Table 6-*SAL*. We show results only for Panel *B* (Equation 6.2). The coefficients for Panels *A* and *C* of Table 6-*SAL* are very close to those in Table 5, except that the negative coefficient on *INDEP* for *Q* for the prospective 1991-1993 period, reported in Panel *A* of Table 5, loses significance in Table 6-*SAL*.

The growth controls in Table 6-*SAL* do not change the central implication from Tables 4 and 5: Poor prior firm performance over the last several years predicts greater future board independence. However, firms with more independent boards do not achieve improved performance. There is no consistent evidence that either recent past (1988-1990) firm or industry growth or future firm growth prospects (proxied by *GrSAL* 91-93) affects board independence in early 1991. We do find evidence of a negative relationship between future industry growth during 1991-1993 and board independence in early 1991. This relationship is significant using *OPI/AST* as the performance measure, and marginally significant for the other two performance measures. We have no good explanation for this correlation.

Table 6 –SAL
Simultaneous Equations Estimates With Controls for
Firm and Industry Sales Growth and Growth Opportunities

Simultaneous equations (three stage least squares) regression results for various performance variables on board independence and stock ownership for 928 large U.S. public companies for 1988-1990 and 1991-1993, with controls for firm and industry sales growth in the recent past and for growth opportunities. The instrumental variables and system of equations are defined in Parts IV.B and C. The performance variables *Q*, *OPI/AST*, and *SAL/AST* are defined in Part III.C. *Q* 88-90 means average *Q* during 1988-1990 and similarly for other performance variables. *GrSAL* 88-90 means fractional growth in firm sales from 1987 to 1990 and similarly for *GrSAL* 91-93. Board and stock ownership variables are based on early 1991 data; 302 industry groups are constructed on the basis of 4-digit SIC codes from Compustat. Sample size varies from 552 to 684 because of missing data. *t*-statistics are in parentheses. Significant results ($p < .05$) are in **boldface**.

Panel *B*: Equation 6.2 (Board Independence as Dependent Variable)

Dependent Variable	Independent Variables (also includes CEO ownership, Outside director ownership, number of outside 5% holders, Log(firm size), but coefficients not shown)						Adj. R^2
	Firm performance measure	Firm performance	*GrSAL* 88-90	Industry sales growth 88-90	*GrSAL* 91-93	Industry sales growth 91-93	
INDEP	*Q* 88-90	**-.20 (-6.05)**	-.001 (-.35)	-.16 (-.29)	**.001 (2.34)**	-.77 (-1.67)	.176
	OPI/AST 88-90	**-2.03 (-8.19)**	-.001 (-1.20)	-.46 (-.80)	.001 (.21)	**-1.58 (-3.05)**	.190
	SAL/AST 88-90	**-.14 (-6.35)**	**-.001 (-2.27)**	-.56 (-1.10)	.001 (1.21)	-.75 (-1.69)	.180

Table 6-OPI
Simultaneous Equations Estimates With Controls for
Firm and Industry Operating Income Growth and Growth Opportunities

Simultaneous equations (three stage least squares) regression results for various performance variables on board independence and stock ownership for 928 large U.S. public companies for 1988-1990 and 1991-1993, with controls for firm and industry operating income growth in the recent past and for growth opportunities. The instrumental variables and system of equations are defined in Parts IV.B and C. The performance variables *Q*, *OPI/AST*, and *SAL/AST* are defined in Part III.C. *Q* 88-90 means average *Q* during 1988-1990 and similarly for other performance variables. *GrOPI* 88-90 means fractional growth in firm operating income from 1987 to 1990 and similarly for *GrOPI* 91-93. Board and stock ownership variables are based on early 1991 data; 302 industry groups are constructed on the basis of 4-digit SIC codes from Compustat. Sample size varies from 552 to 684 because of missing data. *t*-statistics are in parentheses. Significant results ($p <$ .05) are in **boldface**.

Panel *B*: Equation 6.2 (Board Independence as Dependent Variable)

Dependent Variable	Independent Variables (also includes CEO ownership, Outside director ownership, number of outside 5% holders, Log(firm size), but coefficients not shown)						Adj. R^2
	Firm performance measure	Firm performance	*GrOPI* 88-90	Industry operating Income growth 88-90	*GrOPI* 91-93	Industry operating Income growth 91-93	
INDEP	*Q* 88-90	**-.22 (-5.68)**	.001 (-.78)	-.55 (-.78)	-.67 (-.19)	**-.20 (-2.03)**	.154
	OPI/AST 88-90	**-2.03 (-8.19)**	-.001 (-.80)	-.46 (-.80)	.0001 (.21)	**-.16 (-3.01)**	.190
	SAL/AST 88-90	**-.17 (-5.59)**	-.0001 (-.58)	-.39 (-.58)	.0002 (.74)	-.17 (-1.84)	.162

We also rerun the regressions in Table 6 using growth in operating income instead of growth in sales as the growth measure. Table 6-*OPI* shows Panel *B* of this revised table. Panels *A* and *C* are omitted; they are similar to the corresponding (omitted) panels in Table 6-*SAL*. Once again, the growth controls do not affect the negative correlation between firm performance in 1988-1990 and board independence in early 1991. There is again some evidence in Table 6-*OPI* of a negative correlation between industry growth prospects (proxied by industry growth in 1991-1993) and board independence. The coefficient on industry operating income growth in 1991-1993 is significantly negative for *Q* and *OPI/AST*, and marginally significant for *SAL/AST*. As before, we have no good explanation for this correlation.

D. Robustness Check Using 1988 Board Composition and Ownership Data

As a check on our results, we collect board composition and share ownership data in early 1988 for a randomly chosen subsample of 205 firms, and compute a 1988 measure of board independence, which we label *INDEP88*. We run both OLS regressions comparable to Table 4 and 3SLS regressions comparable to Table 5. We report the 3SLS results in Table 5-1988 below. OLS regressions with measures of firm performance as the dependent variable produce coefficient estimates similar to the 3SLS results reported in Panel *A* of Table 5-1988. As we saw for the full sample with 1991 board data, there are hints that greater board independence not only does not improve performance, it may lead to worse performance. In Panel *A*, the coefficients on board independence are negative for all three performance variables for the prospective 1988-1990 period, and the coefficient for *OPI/AST* is statistically significant.

Panel *B* of Table 5-1988 tests for a correlation running from poor past performance to greater board independence. We find evidence of such a correlation. Recent past performance (during 1985-1987) correlates significantly and negatively with board independence in early 1988 for *Q* and *OPI/AST*, and negatively but not significantly for *SAL/AST*. Moreover, for the full 1991 sample, 1985-1987 performance correlates significantly and negatively with board independence in 1991 for all three performance variables (regression results omitted). These results confirm similar evidence from Tables 4 and 5, and reinforce the inference that poorly performing firms respond by increasing board independence.

Table 5-1988
Simultaneous Equations Regressions for 1988 Subsample

Simultaneous equations (three stage least squares) regression results for various performance variables on board independence and stock ownership for 205 large U.S. public companies for 1985-1987 and 1988-1990. The instrumental variables and system of equations are defined in Part IV.B, and are the same as in Table 5, except that *INDEP88* replaces *INDEP* in all equations. The performance variables *Q*, *OPI/AST*, and *SAL/AST* are defined in Part III.C. *Q* 88-90 means average *Q* during 1988-1990 and similarly for other performance variables. Board and stock ownership variables are based on early 1988 data. Industry control for each regression in Panel *A* is the mean of the dependent variable for that regression for each firm's industry group; 302 industry groups are constructed on the basis of 4-digit SIC codes from Compustat. Sample size varies from 195 to 201 because of missing data. *t*-statistics are in parentheses. Significant results ($p < .05$) are in **boldface**.

Panel *A*: Firm Performance as Dependent Variable

Dependent Variable: Firm Performance	Independent Variables (other independent variables same as in Panel *A* of Table 5, but not shown)	Adj. R^2
	Board Independence in Early 1988 (*INDEP*88)	
Q 88-90	-.27 (-1.53)	.447
OPI/AST 88-90	**-.06 (-2.24)**	.139
SAL/AST 88-90	-.18 (-1.31)	.492

Panel *B*: Board Independence as Dependent Variable

Dependent Variable	Independent Variables (other independent variables same as in Panel *B* of Table 5, but not shown)		Adj. R^2
	Firm Performance Measure	Firm Performance	
INDEP88	*Q* 85-87	**-.32 (-2.49)**	.113
	OPI/AST 85-87	**-2.59 (-2.59)**	.185
	SAL/AST 85-87	-.06 (-1.40)	.168

Panel *C*: CEO Ownership

Dependent Variable	Independent Variables (other independent variables same as in Panel *C* of Table 5, but not shown)		Adj. R^2
	Firm Performance Measure	Firm Performance	
CEO Ownership	*Q* 85-87	-3.03 (-1.12)	.070
	OPI/AST 85-87	3.26 (.21)	.084
	SAL/AST 85-87	2.55 (1.84)	.086

E. Robustness Check Using Changes in Board Composition From 1988-1991

The tables above report evidence that firms that have performed poorly in the past have more independent boards than other firms. This suggests, but cannot prove, that there is cause and effect—that these firms increase the independence of their boards in response to poor performance. These strong results contrast to mixed results from other studies on whether firm performance affects board composition (we discuss studies in

Part II.B). The results that we report above are based on absolute levels of board independence. We explore in this section the reasons for these differing results. We begin by asking, in an ordinary least squares framework, whether firms that performed poorly in the recent past (1985-1987) or contemporaneously (1988-1990) measurably increase their level of board independence between 1988 and 1991 (the two dates at which we measure board composition). This approach is similar to that used in the earlier studies. Here the evidence is equivocal.

Using the subsample of 205 firms for which we have board composition data for both 1988 and 1991, we construct a measure of *change* in board independence from 1988 to 1991: *δINDEP = INDEP - INDEP88*. In Table 7, *δINDEP* is the dependent variable, and different measures of recent past (1985-1987) and contemporaneous (1988-1990) performance and growth are the principal independent variables.

If recent past or contemporaneous poor performance (slow growth) drives board independence, the coefficients in Table 7 should be negative. In fact, however, Table 7 offers no evidence of a correlation between change in board composition and recent past or contemporaneous performance or growth. The signs on the coefficients vary and most *t*-statistics are small. This nonresult is consistent with the mixed results found by other researchers.

Table 7
Effect of Change in Board Independence on Performance and Growth

Change in board independence for 205 large U.S. public companies between early 1988 and early 1991. The performance variables are defined in Part III.C, and the growth variables are defined in Part IV.C. Board composition data is from early 1988 and early 1991. Industry control for each regression is the mean of that variable for each firm's industry group; 302 industry groups are constructed on the basis of 4-digit SIC codes from Compustat. Sample size varies from 195 to 201 because of missing data. *t*-statistics are shown in parentheses. Significant results ($p < .05$) are in **boldface**.

Dependent Variable	Independent Variables (industry control and log(1987 sales) are included in the regressions but are not shown)				Adj. R^2
	Performance or Growth Variable	Recent Past Performance or Growth (Same Variable over 1985-1987)	Contemporaneous Performance or Growth (Same Variable over 1988-1990)	Board Size	
δINDEP = INDEP - INDEP 88	*Performance Variables*				
	Q	-.02 (-.70)	-.01 (-.20)	-.001 (-.24)	-.021
	OPI/AST	.10 (.31)	-.18 (-.52)	.004 (.54)	-.032
	SAL/AST	-.09 (-1.14)	.17 (1.93)	.002 (.40)	.005
	Growth Variables				
	GrAST	-.001 (-.24)	-.001 (-.12)	.002 (.28)	-.028
	GrSAL	-.001 (-.33)	-.001 (-1.00)	.004 (.73)	-.022
	GrOPI	-.001 (-.23)	.001 (.31)	.003 (.53)	-.031

The story changes when we move to a simultaneous equations framework. Table 8 uses the same equations and instrumental variables as Table 5, except that we replace *INDEP* with *δINDEP*. Panel *C* on CEO ownership is omitted. In Panel *A* of Table 8, there is no significant relationship between change in board independence from 1988 to 1991, and subsequent firm performance in 1991-1993. This is consistent with our earlier conclusion that firms with more independent boards do not perform better.

In Panel *B*, there is a significant negative correlation between contemporaneous performance (during 1988-1991) and change in board independence over the same period for *Q* and *OPI/AST*, but not for *SAL/AST*. This is generally consistent with poorly performing firms responding by increasing the independence of their boards.

Table 8
Simultaneous Equations Estimates for Changes in Board Independence

Simultaneous equations (three stage least squares) regression results for various performance variables on change in board independence from 1988 to 1991 (*δINDEP*) and stock ownership for 205 large U.S. public companies for 1988-1990 and 1991-1993. The instrumental variables and system of equations are the same as in Table 5, except that *δINDEP* replaces *INDEP* in all equations. The performance variables *Q*, *OPI/AST*, and *SAL/AST* are defined in Part III.C. *Q* 88-90 means average *Q* during 1988-1990 and similarly for other performance variables. Board composition is based on data from early 1988 and early 1991; stock ownership is based on early 1991 data. Industry control for each regression in Panel *A* is the mean of the dependent variable for that regression for each firm's industry group; 302 industry groups are constructed on the basis of 4-digit SIC codes from Compustat. Sample size varies from 195 to 201 because of missing data. *t*-statistics are in parentheses. Significant results ($p < .05$) are in **boldface**.

Panel *A*: Firm Performance as Dependent Variable

Dependent Variable	Independent Variables (other independent variables same as in Panel *A* of Table 5, but not shown)	Adj. R^2
	δINDEP	
Q 88-90	**-.92 (-2.12)**	.372
Q 91-93	-.50 (-1.07)	.403
OPI/AST 88-90	**-.15 (-2.20)**	.122
OPI/AST 91-93	.14 (1.36)	.063
SAL/AST 88-90	.33 (1.12)	.508
SAL/AST 91-93	.36 (1.35)	.612

Panel *B*: Change in Board Independence as Dependent Variable

Dependent Variable	Independent Variables (other independent variables same as in Panel *B* of Table 5, but not shown)		Adj. R^2
	Firm Performance Measure	Firm Performance	
δINDEP	*Q* 88-90	**-.12 (-2.75)**	.033
	OPI/AST 88-90	**-2.00 (-3.36)**	.043
	SAL/AST 88-90	.01 (.30)	-.007

A puzzle, given the strong *t*-statistics in Panel *B* of Table 5, is why the negative correlation in Panel *B* of Table 8 between 1988-1990 performance and 1988-1991 changes in board independence is not stronger. Perhaps the strategy of increasing board independence in response to poor performance, or not doing so if the firm is doing well, emerges over time in response to persistent performance. If so, the strategy will be reflected more clearly in the absolute levels of board independence that we rely on in Table 5 than in the changes in board independence over a limited time period that we rely on in Table 8.

F. Robustness Check: Nonlinear Relationship Between Board Independence and Firm Performance

The OLS and 3SLS regressions above provide evidence that poor firm performance leads firms to increase their board independence. There is no evidence that this strategy improves future performance, and hints of a *negative* relationship between board independence and future firm performance. To see if we can strengthen these hints, this section explores a possible nonlinear relationship between board independence and future firm performance. For example, it could be valuable for firms to have a significant number of inside directors—for example 30%—to achieve the benefits of these directors' firm-specific knowledge, but thereafter it may be unimportant or even detrimental to further increase the proportion of inside directors. Similarly, it could be valuable to have more independent than inside directors, a majority of independent directors,[57] or a 60% supermajority of independent directors.[58] It could also be detrimental to have a supermajority-independent board with a high proportion of independent directors (and hence too few inside or affiliated directors).[59]

We test these hypotheses in Table 9 using dummy variables to divide boards into four independence ranges defined as follows:

- *Dummy1*: equal to 1 if *INDEP* < 0 (more inside than independent directors); and 0 otherwise;
- *Dummy2:* equal to 1 if 0 < *INDEP* < 0.2 (a 50-50 to 60-40 split between independent and inside directors); and 0 otherwise;
- *Dummy3*: equal to 1 if 0.2 < *INDEP* < 0.4 (a 60-40 to 70-30 split between independent and inside directors); and 0 otherwise; and
- *Residual category*: highly independent boards, with *INDEP* > 0.4.

Other independent variables are the same as in Table 4, but are not shown in Table 9 because their coefficients and *t*-statistics are virtually identical to Table 4. About 15% of our sample has *Dummy1* = 1; 15% of the sample has *Dummy2* = 1; 20% of the sample

57. *See* Thomas H. Noe & Michael J. Rebello, The Design of Corporate Boards: Composition, Compensations, Factions, and Turnover (1997) (working paper, Georgia State Univ. College of Business Administration) (theoretical work); Byrd & Hickman (1992), *supra* note 9 (empirical work).

58. *See* Weisbach (1988), *supra* note 8; James F. Cotter, Anil Shivdasani & Marc Zenner, *Do Independent Directors Enhance Target Shareholder Wealth During Tender Offers?*, 43 J. FIN. ECON. 195 (1997).

59. The only effort we know of to assess whether firms with highly independent boards perform differently from other firms is Fosberg (1989), *supra* note 24 (no significant difference in performance between firms with more than 80% outside directors and firms with 50-67% outside directors).

has *Dummy 3* = 1; the remaining 50% of the firms are in the residual category of highly independent boards.

Table 9
OLS Regressions: Firm Performance with Board Independence Dummy Variables

Regression results for various performance variables on dummy variables for board independence and stock ownership variables for 928 large U.S. public companies for 1991-1993. The performance variables *Q, OPI/AST*, and *SAL/AST* are defined in Part III.C. *Q* 91-93 means average *Q* during 1991-1993 and similarly for other performance variables. Board and stock ownership variables are based on early 1991 data. Industry control for each regression is the mean of the dependent variable for that regression for each firm's industry group; 302 industry groups are constructed on the basis of 4-digit SIC codes from Compustat. Sample size varies from 552 to 684 because of missing data. *t*-statistics are in parentheses. Significant results ($p < .05$) are in **boldface**.

Dependent Variable	Independent Variables (other independent variables same as Table 4 but not shown)			Adj. R^2
	***Dummy1* = 1 if *INDEP* < 0; otherwise = 0**	***Dummy2* = 1 if 0 < *INDEP* < 0.2; otherwise = 0**	***Dummy3* = 1 if 0.2 < *INDEP* < 0.4; otherwise = 0**	
Q 91-93	.16 (1.52)	.15 (1.68)	**.19 (2.56)**	.428
OPI/AST 91-93	-.002 (-.17)	.01 (.58)	.02 (1.58)	.214
SAL/AST 91-93	.09 (1.64)	-.004 (-.08)	-.035 (-.90)	.699

Table 9 does not provide strong evidence of breakpoints. The coefficients are mostly insignificant, and sometimes vary in sign. In separate regressions (not shown), we further explore a possible nonlinear relationship between board independence and firm performance by rerunning the regressions in Table 4 with $INDEP^2$ as an additional control variable. The coefficient on $INDEP^2$ varies in sign and is insignificant for all performance variables.

G. Results for Board Size

Two studies report an inverse correlation between board size and firm performance. Yermack reports a significant negative correlation between board size and *Q, SAL/AST, OPI/AST*, and *OPI/SAL* for large U.S. public firms.[60] Eisenberg, Sundgren and Wells report a negative correlation between performance and board size for small and midsize Finnish firms.[61] In contrast, Ferris and coauthors find a positive and (depending on other control variables) sometimes significant correlation between log(board size in 1995) and ratio of market value to book value in 1997.[62] Mak and Li find a significant and *positive*

60. *See* Yermack (1996), *supra* note 21.
61. *See* Theodore Eisenberg, Stefan Sundgren & Martin T. Wells, *Larger Board Size and Decreasing Firm Value in Small Firms*, 48 J. FIN. ECON. 35 (1998).
62. *See* Ferris, Jagannathan & Pritchard (2002), *supra* note 17.

correlation between Tobin's q and board size for Singapore firms in OLS regressions, but the coefficient changes sign in two-stage-least-squares (2SLS) regressions.[63]

Our results cast further doubt on the robustness of any correlation between board size and firm performance. In Tables 4 and 5, we find hints, but no solid evidence, of the inverse correlation found by Yermack. For example, in Table 5, board size takes a significant negative coefficient for 1991-1993 for *SAL/AST*, a negative and marginally significant coefficient for *Q*, and is insignificant and of the opposite (positive) sign for *OPI/AST*. We also run regressions (not shown) using *OPI/SAL* as a performance variable, for comparability with Yermack; board size is not significant. We obtain similarly equivocal results in regressions (not shown) using our 1988 subsample, where board size is again significant and negative only for SAL/AST.

One reason why our results differ from Yermack's is that board size is known to be endogenously related to many other factors that may correlate with performance, including industry, inside share ownership, firm size, and board independence. Yermack includes controls for all of these other factors, but perhaps regression results are sensitive to how the control is conducted, or to whether one uses an OLS or a simultaneous equations approach. For example, Mak and Li report that board independence (which we measure differently than Yermack) predicts the board size of Singapore firms, using a 2SLS approach, and also that the sign of the coefficient on board size differs in OLS and 2SLS regressions of Tobin's q on board size and other explanatory variables.[64]

H. Results for Share Ownership

Board monitoring is one possible way to induce good firm performance. A potential substitute is to provide incentives to management through stock ownership. However, there is no evidence, either from the OLS regressions in Panel *A* of Table 4 or the 3SLS regressions in Panel *A* of Table 5, that higher CEO share ownership translates into improved future performance.[65]

An alternate possibility is that CEOs are rewarded through higher stock ownership for performing well in the past: stock-based compensation serves as a reward, even though it is not an effective incentive.[66] Panel *C* of Table 5 provides evidence of a positive correlation between *past* performance and CEO ownership. However, this possible link between performance and future CEO share ownership is not confirmed in Table 5-1988, where we use 1985-1987 performance and 1988 board and share ownership data.

There are hints, in both the OLS regressions in Table 4 and the 3SLS regressions in Table 5, that stock ownership by outside directors correlates with improved performance.

63. *See* Mak & Li (2001), *supra* note 19.

64. *See id.*, at 249-52.

65. For a sampling of other studies on the relationship between inside ownership and performance, see Harold Demsetz & Belen Villalonga, *Ownership Structure and Corporate Performance*, 7 J. CORP. FIN. 209 (2001); Charles P. Himmelberg, R. Glenn Hubbard & Darius Palia, *Understanding the Determinants of Managerial Ownership and the Link Between Ownership and Performance*, 53 J. FIN. ECON. 353 (1999); Stacey R. Kole, *Managerial Ownership and Firm Performance: Incentives or Rewards?*, 2 ADVANCES FIN. ECON. 119 (1996).

66. *See* Kole (1997), *supra* note 65.

The coefficients on outside director ownership are positive although insignificant for all performance variables for the prospective 1991-1993 period. We return to this issue in Part VI.B.

There is no evidence, either in the OLS regressions in Table 4 or the 3SLS regressions in Table 5, that monitoring by outside 5% blockholders affects firm performance. In both tables, the coefficients in these regressions on number of outside 5% blockholders vary in sign, are significantly negative for *Q*, but are significantly positive for *SAL/AST*.

V. Correlation Between Board Independence and Firm Growth

In this section, we investigate the relationship between board independence and firm growth. The growth measures we use are:

Variable	**Definition**
GrAST xx yy	percentage growth in assets from year *xx* - 1 to year *yy*; for example *GrAST* 85-87 is percentage growth in assets from 1984 (treated as the baseline year) to 1987
GrSAL xx yy	percentage growth in sales from year *xx* -1 to year *yy*
GrOPI xx yy	percentage growth in operating income from year *xx* - 1 to year *yy* (we discard observations with negative initial *OPI*)

Because firm growth may both determine and be determined by board independence, we use a simultaneous equations (3SLS) structure. We estimate the following system of equations:

- *Equation 10.1: firm growth measure* = f_1 (*INDEP*, CEO ownership, board size, outside director ownership, number of outside 5% holders, log(firm size), industry growth control)
- *Equation 10.2: INDEP* = f_2 (firm growth measure, CEO ownership, outside director ownership, number of outside 5% holders, log(firm size))
- *Equation 10.3: CEO ownership* = f_3 (firm growth measure, outside director ownership, log(firm size)

The endogenous variables and corresponding instrumental variables we use are:

- *firm growth measure*: for *GrSAL* and *GrOPI*, we use *GrAST* as an instrumental variable; for *GrAST*, we use *GrSAL* as an instrumental variable;
- *board independence*: f_{indep}; and
- *CEO ownership:* share ownership by all directors and officers.

Our results are presented in Table 10. There is evidence from Panel *B* that slow firm growth in sales and assets (but not operating income) predicts greater board independence. This is consistent with the evidence we report in Part IV that poor performance predicts greater board independence. However, there is no evidence from Panel *A* of Table 10 that greater board independence leads to either faster or slower growth. The coefficients in Panel *A* are insignificant and vary in sign.

Table 10
Simultaneous Equations: Growth Accounting Variables and Board Composition

Simultaneous equations (three stage least squares) regression results for various growth variables for 928 large U.S. public companies for 1988-1990 and 1991-1993. The instrumental variables, system of equations, and growth variables *GrAST*, *GrSAL*, and *GrOPI* are defined in Part V. *GrAST* 88-90 means percentage growth in assets during the period from 1984 to 1987, and similarly for other variables. Board and stock ownership variables are based on early 1991 data. Industry control for each regression in Panel *A* is the mean of the dependent variable for that regression for each firm's industry group; 302 industry groups are constructed on the basis of 4-digit SIC codes from Compustat. Sample size varies from 552 to 684 because of missing data. *t*-statistics are shown in parentheses. Significant results ($p < .05$) are in **boldface**.

Panel *A*: Equation 10.1 (Firm Growth as Dependent Variable)

Dependent Variable	Independent Variables (other independent variables same as in Panel *A* of Table 5, but not shown)	Adj. R^2
	Board Independence (*INDEP*)	
GrAST 91-93	5.67 (1.46)	.023
GrSAL 91-93	3.74 (.93)	.050
GrOPI 91-93	-1.42 (-.12)	.039

Panel *B*: Equation 10.2 (Board Independence as Dependent Variable)

Dependent Variable	Independent Variables (other independent variables same as in Panel *B* of Table 5, but not shown)		Adj. R^2
	Growth Measure	Firm Growth	
	GrAST 88-90	**-.002 (-5.03)**	.152
INDEP	*GrSAL* 88-90	**-.002 (-4.29)**	.142
	GrOPI 88-90	.0001 (1.14)	.114

VI. Conclusion

We find a reasonably strong *inverse* correlation between firm performance in the recent past and board independence. However, there is no evidence that greater board independence leads to improved firm performance. If anything, there are hints that greater board independence may impair firm performance. The weak results in this Article, combined with similar results from the other research surveyed in Part II.A, do not support the conventional wisdom favoring the monitoring board, with a high degree of board independence. In this concluding section, we explore some reasons why greater board independence may not improve firm performance.

A. The Case for Inside Directors

One reason why increasing board independence doesn't lead to improved performance is that having a reasonable number—even if not a majority—of inside directors could add value. Baysinger and Butler suggest that an optimal board contains a

mix of inside, independent, and perhaps also affiliated directors, who bring different skills and knowledge to the board.[67] Including insiders on the board may make it easier for other directors to evaluate them as potential future CEOs.[68] Insiders also may be better at strategic planning decisions, consistent with Klein's evidence that inside director representation on investment committees of the board correlates with improved firm performance.[69] This "mixed board" explanation is consistent with Klein's evidence that affiliated directors are more likely to be found on the boards of firms that need the affiliated director's expertise, although Klein finds no significant correlation between the proportion of affiliated directors and firm performance.[70]

To be sure, senior managers *could* be invited to board meetings even if they are not board members. But there is no guarantee that they will be invited. Moreover, the interaction between senior managers (other than the CEO) and other directors may be different if the managers have seats on the board, are expected to attend every meeting, must vote, and are expected to participate in board discussions, than if they attend at the CEO's pleasure, speak only when asked to, and could be disinvited to future meetings if the CEO so decides.

A further reason why inside directors may be valuable involves the tradeoff between independence and other factors that affect board decisions. Inside directors are conflicted but well informed. Independent directors are not conflicted but are relatively ignorant about the company. Perhaps independent directors will act more quickly than inside directors if something goes wrong. But they may do the wrong thing if their deliberations are not leavened by the information available to inside directors. Noe and Rebello offer a theoretical model in which having a minority of inside directors improves board decisionmaking, due to their superior information.[71] Westphal offers a qualitative "collaborative board" model, and some supporting survey evidence, suggesting that social ties between the CEO and other board members could enhance board effectiveness; the same could be true for other senior managers who have board positions.[72]

There is also a tradeoff between independence and incentives. Many independent directors own small amounts of their company's shares, and hence have limited incentives to monitor carefully. Inside directors lack independence, but have their human capital, and often most of their financial capital, committed to their company. Hall and Liebman provide evidence of the sensitivity of managers' financial wealth to firm performance.[73] The hypothesis that directors' incentives affect firm performance is

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67. *See* Baysinger & Butler (1985), *supra* note 14.

68. *See* RICHARD F. VANCIL, PASSING THE BATON: MANAGING THE PROCESS OF CEO SELECTION (1987); Weisbach (1988), *supra* note 8.

69. *See* Klein (1998), *supra* note 23, at 277.

70. *See* Klein (2000), *supra* note 49. For a defense of mixed boards based on social interaction among directors, see Donald C. Langevoort, *The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability* (working paper 2000), *at* http://papers.ssrn.com/abstract=241402 (Social Science Research Network).

71. *See* Noe & Rebello (1997), *supra* note 57.

72. *See* James D. Westphal, *Collaboration in the Boardroom: Behavioral and Performance Consequences of CEO-Board Social Ties*, 42 ACAD. MGMT. J. 7 (1999).

73. *See* Brian J. Hall & Jeffrey B. Liebman, *Are CEOs Really Paid Like Bureaucrats?*, 113 Q.J. ECON. 643 (1998).

consistent with the evidence we report in Part VI.B that independent directors may perform better when they hold substantial amounts of a company's stock.

A priori, it is not obvious that independence (without knowledge or incentives) leads to better director performance than knowledge and strong incentives (without independence). Maybe the optimal board has some knowledgeable, incentivized inside directors, and some independent directors—who might thereby become better informed, and could also be better incentivized than many independent directors are today.

B. Interaction Between Independence and Stock Ownership

Bhagat, Carey and Elson report that directors with substantial stock ownership act more quickly to replace the CEO.[74] Bradbury and Mak report that directors of New Zealand firms who represent unaffiliated blockholders are more likely to adopt charter provisions that encourage takeover bids.[75] Consistent with these studies, there are hints in Tables 4 and 5 that independent directors are more effective if motivated by significant stock ownership. To test for this possibility, Table 11 reports OLS results using the interaction between $\log(f_{indep})$ and outside director ownership as a board composition variable, together with $\log(f_{inside})$.

Table 11
OLS Regressions: Interaction Between Board Composition and Stock Ownership

Regression results for various performance variables on $\log(f_{inside})$, stock ownership, and interaction between $\log(f_{indep})$ and outside director ownership, for 928 large U.S. public companies for 1991-1993. The performance variables *Q*, *OPI/AST*, and *SAL/AST* are defined in Part III.C. *Q* 91-93 means average *Q* during 1988-1990 and similarly for other performance variables. Board and stock ownership variables are based on early 1991 data. *t*-statistics are shown in parentheses. Significant results ($p < .05$) are in **boldface**.

Dependent Variable	Independent Variables (other independent variables same as Table 4, but not shown)	
	$\log(f_{inside})$	$\log(f_{indep})$ * (Outside Director Ownership)
Q 91-93	**.17 (2.43)**	.02 (.90)
OPI/AST 91-93	.014 (1.69)	**.008 (2.41)**
SAL/AST 91-93	**.15 (3.35)**	**.04 (2.04)**

In Table 11, the coefficients on $\log(f_{inside})$ are positive and statistically significant for Q and *SAL/AST,* and marginally significant for *OPI/AST.* This is consistent with the negative coefficients on *INDEP* for the regression with these performance variables in Table 4. It is also consistent with the usually positive and sometimes significant

74. *See* Sanjai Bhagat, Dennis C. Carey & Charles M. Elson, *Director Ownership, Corporate Performance, and Management Turnover*, 54 BUS. LAW. 885 (1999).

75. *See* Michael E. Bradbury & Y.T. Mak, *Ownership Structure, Board Composition and the Adoption of Charter Takeover Procedures*, 6 J. CORP. FIN. 165 (1999).

coefficients on $\log(f_{inside})$ in separate regressions (not shown), in which we replace *INDEP* as an independent variable with $\log(f_{inside})$ and $\log(f_{indep})$ as separate independent variables.

The interaction variable $\log(f_{indep})$* (outside director ownership) is positive for all three performance variables and is significant for *OPI/AST* and *SAL/AST*. This contrasts with the usually *negative* and sometimes significant coefficients on $\log(f_{indep})$ in separate regressions (not shown), in which we replace *INDEP* as an independent variable with $\log(f_{inside})$ and $\log(f_{indep})$ as separate independent variables. Thus, Table 11 supports the hypothesis that independent directors who hold significant stock positions may add value, while other independent directors do not.

C. The Arguments for Independent Directors

How might one make the case for a modified version of the conventional wisdom that favors highly independent boards? One possibility, explored in the previous section, is that independent directors need to be better incentivized. A second possibility is that today's "independent" directors aren't independent enough. Perhaps, as Gilson and Kraakman argue, "corporate boards need directors who are not merely independent [of management], but who are *accountable* [to shareholders] as well."[76] But if this is true, institutional investors may need to put their own representatives on boards of directors, a step that few are interested in and which is difficult under current U.S. rules.[77]

A third possibility is that some directors who are classified as independent are not truly independent of management, because they are beholden to the company or its current CEO in ways too subtle to be captured in customary definitions of "independence." For example, some nominally independent directors may serve as paid advisors or consultants to a company, or may be employed by a university or foundation that receives financial support from the company. Unfortunately, the data needed to capture these relationships are not currently available.

Perhaps, too, some directors have personal relationships with the CEO that affect their independence. This possibility is consistent with evidence that directors who were appointed during the current CEO's tenure are more generous in determining the CEO's compensation.[78] One way to begin to untangle these subtle relationships would be for the SEC to require additional disclosure of financial or personal ties between directors (or the organizations they work for) and the company or its CEO.

Perhaps independent directors who have served for too long become, over time, less vigorous monitors. Conversely, perhaps directors who were on the board before the CEO are more truly independent than shorter-tenured directors. Evidence favoring the latter possibility is offered by a study of bank boards by Mishra and Nielsen. They find that return on assets correlates inversely with board independence (measured as fraction of independent directors), but *positively* with a measure of the average tenure of the

76. Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863, 865 (1991).

77. *See* Bernard Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520 (1990); MARK J. ROE, STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE (1994).

78. *See* Robert W. Holthausen & David F. Larcker, Board of Directors, Ownership Structure, and CEO Compensation (1993) (working paper, University of Pennsylvania, Wharton School); Yermack (1996), *supra* note 21.

independent directors relative to the CEO's tenure.[79] Age may matter, too. Older directors, at some point, likely become less effective. Many firms have director retirement policies, often at age seventy, but whether these are pegged to the right age is unknown.

A fourth possibility is that some types of independent directors may be valuable, while others are not. Maybe CEOs of companies in other industries (who are, by number, the majority of independent directors) are too busy with their own business, know too little about a different business, and are overly generous in compensating another CEO. Maybe "visibility" directors—well-known persons with limited business experience, often holding multiple directorships and adding gender or racial diversity to a board, are not effective on average. But this explanation suggests that to push for greater board independence may be fruitless or even counterproductive, unless independent directors have particular attributes, which are currently unknown.

A final possibility is that independent directors can add value, but only if they are embedded in an appropriate committee structure. This would let independent directors perform the monitoring function that they are best suited for, while letting inside and affiliated directors perform the informing and advising function to which they bring more firm-specific expertise. However, most large firms already have such committee structures and Klein finds little evidence that the principal outsider-dominated "monitoring" committees—audit, compensation, and nominating committees—affect performance, regardless of how they are staffed.

D. Policy Implications

What would the implications be if the conventional wisdom is wrong and our data are right—if greater board independence does not improve, and may reduce, firm performance? Steps like insisting that independent directors own more shares, or that they be more completely independent, are worth trying. Focusing on board procedures, such as an annual meeting of independent directors devoted to reviewing management's performance and appointing a lead independent director, as Millstein and MacAvoy advocate, may be valuable.[80]

Our results do not support a return to the 1960s, when boards were insider dominated and usually passive. Our results do suggest that investors should not complain if companies experiment with departures from the current norm of a "supermajority independent" board with only one or two inside directors. A board with, for example, six independent directors, four inside directors, and one affiliated director, instead of nine independent directors and two inside directors, might bring subtle benefits and conveys no obvious harm. The independent directors will still numerically dominate the board and can take appropriate action in a crisis.

79. *See* Chandra S. Mishra & James F. Nielsen, *Board Independence and Compensation Policies in Large Bank Holding Companies*, FIN. MGMT., Autumn 2000, at 51.

80. *See* Ira M. Millstein & Paul W. MacAvoy, *The Active Board of Directors and Improved Performance of the Large Publicly Traded Corporation*, 98 COLUM. L. REV. 1283 (1998); *see also* Martin Lipton & Jay W. Lorsch, *A Modest Proposal for Improved Corporate Governance*, 48 BUS. LAW. 59 (1992).

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Appendix: Results Using Market-Adjusted Returns (MAR) as a Performance Variable

As we noted in Part III.C, stock price returns must be used with caution as a performance measure because they are susceptible to investor anticipation. If investors fully anticipate the effects of board composition on performance, stock returns will be insignificant, even if a significant correlation between performance and board independence exists. For this reason, we rely mostly on Tobin's q (Q), the ratio of operating income to assets (*OPI/AST*), and the ratio of sales to assets (*SAL/AST*) as our performance measures. However, results using stock market returns as a performance measure are consistent with these results.

The tables below report selected OLS and 3SLS regression using market-adjusted returns (*MAR*) as a dependent variable. *MAR* is stock price return adjusted for overall market movements, but not for firm specific risk as proxied by β. We obtain similar but noisier (higher standard deviation) results using cumulative abnormal returns, which are adjusted both for overall market returns and for firm-specific β.

OLS Regression: *MAR* on Board Independence and Ownership Structure

Ordinary least squares regression results for market-adjusted returns (*MAR*) on board independence and stock ownership for 928 large U.S. public companies for 1988-1990 and 1991-1993. *MAR 88-90* means average *MAR* during 1988-1990 and similarly for other periods. Board and stock ownership variables are based on early 1991 data. Industry control for each regression is the mean of the dependent variable for that regression for each firm's industry group; 302 industry groups are constructed on the basis of 4-digit SIC codes from Compustat. Sample size varies from 552 to 684 because of missing data. *t*-statistics are in parentheses. Significant results ($p < .05$) are in **boldface** (not shown for firm size or industry control).

Dependent Variables	Independent Variables							Adj. R^2
	INDEP	Board size	CEO ownership	Outside director ownership	No. of Outside 5% Holders	Log(firm size)	Industry control	
MAR 88-90	**-.19 (-2.60)**	.001 (.05)	.003 (1.44)	-.001 (-.28)	**-.08 (-4.80)**	.01 (.35)	.23 (.66)	.055
MAR 91-93	.09 (1.24)	.009 (1.34)	**.005 (2.08)**	.004 (1.20)	.02 (1.20)	.01 (.83)	1.00 (6.64)	.087

3SLS Regressions: *MAR* on Board Independence and Ownership Structure

Simultaneous equations (three stage least squares) regression results for market-adjusted returns (*MAR*) on board independence and stock ownership for 928 large U.S. public companies for 1988-1990 and 1991-1993. *MAR* 88-90 means average *MAR* during 1988-1990 and similarly for other periods. Board and stock ownership variables are based on early 1991 data. Industry control for each regression in Panel *A* is the mean of the dependent variable for that regression for each firm's industry group; 302 industry groups are constructed on the basis of 4-digit SIC codes from Compustat. Sample size varies from 552 to 684 because of missing data. *t*-statistics are in parentheses. Significant results ($p < .05$) are in **boldface** (not shown for firm size or industry control).

Panel *A*: Equation 5.1 (Firm Performance as Dependent Variable)

Dependent Variable:	Independent Variables							Adj. R^2
	INDEP	Board Size	CEO Ownership	Outside Director Ownership	No. of Outside 5% Holders	Log (firm size)	Industry Control	
MAR 88-90	**-.19 (-2.33)**	-.001 (-.03)	.003 (.97)	-.001 (-.39)	**-.08 (-5.03)**	.01 (.77)	-.17 (-.20)	.0561
MAR 91-93	.13 (1.55)	.011 (1.24)	.006 (1.94)	.005 (1.35)	.03 (1.82)	.03 (1.63)	.70 (1.30)	.0189

Panel *B*: Equation 5.2 (Board Independence as Dependent Variable)

Dependent Variable	Independent Variables						Adj. R^2
	Firm Performance Measure	Firm Performance	CEO Ownership	Outside Director Ownership	No. of Outside 5% Holders	Log (firm size)	
INDEP	*MAR* 88-90	**-.45 (-5.31)**	**-.01 (-5.52)**	-.002 (-.91)	-.008 (-.55)	.03 (2.49)	.134
	MAR 91-93	**3.17 (2.64)**	**-.03 (-2.59)**	-.018 (-1.33)	-.084 (-1.25)	-.12 (-1.57)	.008

Panel *C*: Equation 5.3 (CEO Ownership)

Dependent Variable	Independent Variables				Adj. R^2
	Firm Performance Measure	Firm Performance	Outside Director Ownership	Log(firm size)	
CEO Ownership	*MAR* 88-90	**9.64 (5.02)**	.11 (1.55)	-1.47 (-4.89)	.066
	MAR 91-93	**35.6 (3.44)**	-.17 (-1.07)	**-2.51 (-3.69)**	.023

FUND OPERATIONS AND GOVERNANCE

THURSDAY, FEBRUARY 26, 2004

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 2:03 p.m. in room SD–538 of the Dirksen Senate Office Building, Senator Richard C. Shelby (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN RICHARD C. SHELBY

Chairman SHELBY. The hearing will come to order.

This afternoon, the Banking Committee continues its examination of the mutual fund industry. Specifically, we will focus on fund operations and governance.

Before I get started, I want to tell the panelists, you have been here twice for one panel, one chance to testify. We appreciate that. We did not bring the ice and the snow earlier when we cancelled everything in the Senate, and we did not bring trouble here either. But we appreciate your patience and your willingness to come again today.

Under the operating structure created by the Investment Company Act of 1940, fund boards contract with service providers for the daily management of the fund. As a result, the typical mutual fund maintains a variety of relationships with investment advisers, transfer agents, and underwriters. Over the course of time, fund operations have become increasingly complex and the need for outside expertise has grown. For instance, the expanded role of intermediaries in the sale and distribution of mutual fund shares that has led to new fees, compensation arrangements, and conflicts of interests.

The recent revelations concerning the fund industry raise serious questions about the transparency of fund operations and the adequacy of current disclosure practices. It seems as if most investors lack a basic understanding of how funds operate and are unaware of the risks, and potential conflicts of interest, that accompany fund operations. Currently, mutual funds are required to disclose a significant amount of information to investors. Many contend these disclosures are confusing and omit useful information. We will consider various operational issues and compensation arrangements to evaluate how these practices serve investors today. We will also evaluate how the SEC's disclosure regime might be revised to ensure that investors receive clear, concise, and meaningful disclosure that enhances decisionmaking rather than impede it.

Given the complex operating structure of funds, shareholders must rely on fund boards to police conflicts of interest and protect shareholder interests. With such an important responsibility to shareholders, I believe it is critical that boards exercise strong and active leadership and sound judgment. Some contend that the recent scandals are evidence of an erosion of fund governance. We will review the role of independent directors and examine how changes to fund governance can better minimize conflicts of interest and reinvigorate the boardroom culture to better protect shareholder interests.

To discuss these issues with us today, we have a distinguished panel. No stranger to the Banking Committee, Chairman Dave Ruder. Professor Ruder was the Chairman of the SEC when we spent a lot of time here together. He is also the Chairman of the Independent Directors Forum; David Pottruck, President, Charles Schwab; Mellody Hobson, President, Ariel Capital Management; and John Bogle, founder of Vanguard Funds.

I look forward to all of your testimony here today. Your written testimony will be made part of the hearing record in its entirety. Chairman Ruder, we will start with you, and welcome you again to the Banking Committee, where you have appeared many times.

STATEMENT OF DAVID S. RUDER
FORMER CHAIRMAN
U.S. SECURITIES AND EXCHANGE COMMISSION
WILLIAM W. GURLEY MEMORIAL PROFESSOR OF LAW
NORTHWESTERN UNIVERSITY SCHOOL OF LAW
CHAIRMAN, MUTUAL FUND DIRECTORS FORUM

Mr. RUDER. Thank you, Chairman Shelby. I well remember the days of following the market crash of 1987, when I had the pleasure of appearing before this Committee.

Chairman SHELBY. That was one of yours and then Chairman Greenspan and Mr. McDonough's finest hours and days.

Mr. RUDER. I thank you for asking me to testify on the important question of mutual fund reform. I am currently a Professor of Law at Northwestern University School of Law, where I teach securities law, and as you said, I was Chairman of the U.S. Securities and Exchange Commission from 1987 to 1989.

Currently, I serve as the Chairman of the Mutual Fund Directors Forum, a not-for-profit corporation, whose mission is to improve fund governance by promoting the development of vigilant and well-informed directors. We do so by offering continuing education programs to independent directors, providing opportunities for independent directors to discuss matters of common interest, and serving as advocates on behalf of independent directors.

Although I am Chairman of the Forum, these remarks are my own and not made on behalf of the Forum, its members, or any other groups of persons. That is similar to an SEC disclaimer, and I give it gladly.

My written statement contains my suggestions for improvement in mutual fund——

Chairman SHELBY. Speaking for yourself and not for your other members, right?

Mr. RUDER. That is right. My statement deals with corporate governance and identifies several problem areas in mutual fund administration that need special attention.

The most important approach toward increasing protections of mutual fund investors is to enhance the power of independent fund directors and to motivate them to perform their duties responsibly. In seeking these goals and reforms in adviser activities, I believe Congress should rely upon the Securities and Exchange Commission and should refrain from extensive legislation.

In deciding what corporate governance structure is desirable, the Congress and the SEC need to understand that most fund directors are well-informed, dedicated, and active in their supervision of mutual fund advisers. But to say that most fund directors are well-informed, dedicated, and active does not mean that all fund directors share those qualities.

Historically, the mutual funds have been created by investment advisers that are extremely knowledgeable about the securities industry and the intricacies of mutual fund management. Some fund directors who are charged with supervising an adviser may at times be unwilling to challenge the adviser who has the advantage of superior knowledge and resources.

There are some important corporate governance improvements that should be made, many of which have already been proposed or adopted by the SEC.

First, regarding independence, I agree that at least three-fourths of each fund board of directors should be independent of the adviser. I also believe that the chairman of the board of each fund should be independent of the adviser. An independent chairman can control the board agenda, and can control the conduct of board meetings so that important discussions are not truncated, and can provide important and direct liaison with the adviser between board meetings. And both of these reforms have been suggested by the SEC.

Second, regarding fund board operations, the fund boards in the larger complexes should function with committees composed solely of independent directors, including a nominating committee, an audit committee, a compliance committee, and an investment committee. Since most funds are externally managed by the adviser, it is also important that boards of directors have access to their own consultants and advisers. I believe that all independent directors should have independent legal counsel, that mutual fund boards should be able to hire an independent staff on a permanent basis or on an as-needed basis, and that fund boards should be able to hire independent advisers to advise the board in areas such as fund fees and costs, the quality of portfolio executions, and the valuation of fund securities.

Third, regarding compliance, which I regard as all important, I strongly endorse recent SEC actions to improve compliance. Each investment adviser should be required to have a chief compliance officer charged with supervising the compliance functions of the adviser and the service providers to the funds. Although paid by the adviser, the chief compliance officer should report to the fund board, as well as to the adviser. The fund boards should have the

right to set the compensation and to hire and fire the chief compliance officer.

Chairman SHELBY. Chairman Ruder, do any of the funds have a chief compliance officer that you know of today?

Mr. RUDER. A few do.

Chairman SHELBY. A few do.

Mr. RUDER. A few do, but not many.

Chairman SHELBY. Okay.

Mr. RUDER. But there is a growing movement in that regard.

Chairman SHELBY. Absolutely.

Mr. RUDER. Advisers and funds should adopt and implement written compliance policies and procedures. The SEC's recently adopted Investment Advisers Act rule will require the adviser to adopt and to implement written policies and procedures reasonably designed to prevent violation of the Advisers Act by the adviser. Its Investment Company Act rule requires fund boards to adopt written policies and procedures reasonably designed to prevent violations of the securities laws.

I believe these compliance requirements will be extremely helpful in achieving better fund governance. But I believe there are two areas in which no action should be taken. Some have suggested that fund directors or the board chairman should be required to certify to shareholders regarding their oversight activities. I do not believe that such a certification requirement is needed or advisable. Such a requirement is not needed because fund boards are increasingly becoming more active in supervising advisers and service providers, and they will become even more active under new SEC rules. Such a requirement is not advisable because it could deter qualified individuals from serving on boards.

Even under the Sarbanes-Oxley Act, the certification requirement does not reach the board level.

Some also have suggested that a mutual fund oversight board be established for the purpose of overseeing the mutual fund industry in a manner similar to which the Public Company Accounting Oversight Board oversees accountants. I do not believe that such a mutual fund oversight board is necessary. The PCAOB was established in the accounting area because of a lack of power to oversee the accounting industry. In contrast, the SEC has the authority to oversee the mutual fund industry. It is increasing its oversight and rulemaking activities and, thanks to the Congress, has recently been given badly needed additional resources that will help it to perform its oversight functions.

My written statement contains some comments regarding technical areas of fund administration. I want to point to four of them.

First, in my opinion, neither the U.S. Government nor the State governments should attempt to set mutual fund advisory fees. This is a very complex industry and very competitive, and I think——

Chairman SHELBY. Shouldn't the market set the fees?

Mr. RUDER. I believe the market should set the fees, but——

Chairman SHELBY. Does anybody have any disagreement with that on the panel?

Mr. BOGLE. Yes, sir.

Chairman SHELBY. You do? Okay. I will let you continue.

Mr. RUDER. I think that the fees should be set by the directors bargaining in a very vigorous way with the adviser, and there are many subsets of that negotiation which are very important.

Second, I believe that the SEC should mandate that all directed brokerage revenues—those are the revenues that come from portfolio transactions—including soft-dollar payments, should be used for the benefit of the funds and not for the fund advisers.

Third, I believe Congress should enact legislation in one area. It should repeal Section 28(e) of the Securities and Exchange Act, which protects soft-dollar practices, and lets the SEC, by rule, deal with those soft-dollar payment problems.

Fourth, since the SEC is addressing late trading and market timing, no legislation is needed in those areas.

The SEC may be criticized for its failure to engage in earlier action regarding the problems that have emerged in the mutual fund industry. But I regard its recent actions and proposals to be effective in correcting the problems in this very highly complex industry. I believe Congress should rely on the SEC and fund directors to provide effective oversight of the industry and should not seek a legislative solution other than the repeal of Section 28(e).

If Congress should, nevertheless, decide to act, I believe it should limit its action to structural areas, such as having an independent chairman and three-fourths of the board being independent, and possibly to clarifying the powers of the Commission to oversee the industry. But the important thing is that this is such a complex and highly difficult industry to understand that the SEC is the right agency to take action.

Thank you.

Chairman SHELBY. Mr. Pottruck, welcome to the Committee.

STATEMENT OF DAVID S. POTTRUCK
CHIEF EXECUTIVE OFFICER
THE CHARLES SCHWAB CORPORATION

Mr. POTTRUCK. Thank you, Chairman Shelby, Ranking Member Sarbanes—who is not here at the moment—distinguished Members of the Committee. My name is David Pottruck, and I am the CEO of Charles Schwab Corporation. Mutual funds are at the core of our business, and we at Schwab share the Committee's disappointment over the recent events that have propelled mutual funds to the front pages. I am delighted to be here and applaud this Committee's efforts to identify needed reforms.

Schwab is certainly no stranger to the needs of mutual fund investors. We serve more than 8 million individual accounts and more than 2 million 401(k) plan investors with nearly $1 trillion in assets. And perhaps most important from the point of view of individual investors, we pioneered the first no-load mutual fund supermarket.

Before the launch of our no-load, no-transaction-fee mutual fund supermarket in 1992, our clients held about $6 billion in mutual funds at Schwab. Today, our clients have more than $278 billion invested through our company in more than 5,000 funds. Moreover, nearly 90 percent of mutual funds traded today, including many 401(k) plans, are executed via an intermediary, whether Schwab or a competitor of ours.

I do not think I am being too bold when I say that mutual fund supermarkets helped democratize investing for millions of Americans. Supermarkets protect investors from being held captive by a single fund company by providing an array of investment choices. They empower investors by facilitating comparison shopping among funds; they increase competition by allowing investors to move easily from one fund family to another; and they simplify investing by consolidating statements, thereby driving down costs.

In a time of growing consolidation in all of the financial services industry, mutual funds stand out as an admirable exception. Since our supermarket launch, competition has increased, and the number of mutual funds has nearly tripled. Many of these new funds are managed by smaller fund companies that did not even exist a decade ago and could not exist or blossom without the supermarket infrastructure, such as the Ariel funds, represented on today's panel by Mellody Hobson.

As you consider reform, I strongly urge the Committee to remember the very qualities that make mutual fund supermarkets so valuable to investors: Choice, simplicity, disclosure, competition, and convenience.

I would like to briefly outline a few suggestions for the Committee's consideration to underscore these principles.

Number one, investors deserve choice without conflict. Their broker's representative should never have a financial incentive to push one mutual fund over another, and no one at Schwab does.

Number two, all investors need disclosure. They should know, for example, whether a fund company has paid a fee to be on a broker's preferred list.

Number three, having said that, it is important that we focus on the quality, not just the quantity of disclosure. Mutual fund documents are already too complex. There is a danger that additional disclosure will further overwhelm investors. The SEC has made important progress in recent years in its plain-English initiatives. It must apply those principles here as well, or we are just fooling ourselves about helping investors.

Number four, finally, to boost competition and drive down prices, Congress should un-fix sales loads and force broker-dealers to disclose and compete on cost. Mutual funds should be allowed to set a maximum load, but not a minimum, as they do now. Today, Schwab is prevented from selling load funds at reduced charges to the consumer. Moreover, if Congress un-fixes sales loads, the SEC should do away with the confusing proliferation of the load share classes which leave many investors confused. At Schwab, we only offer the same low-cost share class that fund companies offer to investors directly.

This brings us to the issues of choice, convenience, and fairness. One of the highest profile proposals to emerge from the SEC is known as the "Hard 4 p.m. Close." We fully support the intended result. But without further development, this proposal would unnecessarily decrease investor choice, convenience, and fairness. The highway through mutual fund supermarkets and intermediaries, the preferred route for nearly 90 percent of mutual fund purchases, would have a 10-foot-tall speed bump.

Under the SEC's proposal, different investors would face different cutoff times. Imagine three investors who want to buy or to sell $5,000 worth of the same mutual fund, one through a 401(k) plan, one through a brokerage account, and one through an account held directly with the mutual fund. Each investor would have a different cutoff time and potentially a different price for the same transaction. Ironically, it is this kind of disparate treatment of investors that has been the source of concern for the American people and this Committee.

Mr. Chairman, the "Hard 4" needs to become the "Smart 4," which takes the "Hard 4" and goes beyond it to embrace the services investors want. And this further evolved proposal absolutely achieves the goal of preventing orders from being placed after the market closes but without creating inequities among different investors. It requires that preapproved intermediaries utilize the best technology, enhanced compliance and audit requirements, and vigorous enforcement to stamp out illegal late trading.

I provide more details about the "Smart 4" proposal in my written testimony, which I ask to be included in the record.

Chairman SHELBY. Without objection, your entire testimony, all the testimony will be made part of the hearing record.

Mr. POTTRUCK. Thank you.

Finally, Mr. Chairman, let me conclude by saying that we in the mutual fund industry bear the ultimate responsibility for acting in the best interest of our clients. Legislation and regulation can only do so much. Most of the failures that have been publicized were already illegal. They were not a result of inadequate rules but, rather, a failure to follow the letter and the spirit of the rules that we have.

I appreciate the opportunity to share our views on this critical issue, and I look forward to answering any questions that any of you may have.

Chairman SHELBY. Thank you.

Ms. Hobson.

STATEMENT OF MELLODY HOBSON PRESIDENT, ARIEL CAPITAL MANAGEMENT, LLC/ ARIEL MUTUAL FUNDS

Ms. HOBSON. Thank you, Chairman Shelby, Ranking Member Sarbanes, and all of the Members of the Committee. I am honored to be here.

I am President of Ariel Capital Management, the investment adviser to the Ariel Mutual Funds, a small mutual fund company based in Chicago. Our firm's Chairman, John Rogers, founded our firm in 1983 when he was just 24 years old. John began investing at the early age of 12 when his father started buying him stocks every birthday and every Christmas instead of toys. Ultimately, his childhood hobby evolved into a passion that led to the creation of our firm.

At the time of our inception, Ariel was the first minority-owned money management firm in the Nation, in my view a testament to the American Dream. Given our pioneering status, it is part of Ariel's corporate mission to make the stock market the subject of dinner-table conversation in the black community.

With nearly $5.5 billion in assets, Ariel's four no-load mutual funds invest for 280,000 investors. So, our responsibilities are indeed quite large. But in comparison to the largest mutual fund firms in the country, with just 74 employees, we are quite small as a company.

As a small mutual fund company, we are the norm in our industry, not the exception. More than 370 mutual fund companies manage $5 billion or less. As such, I welcome the chance to speak on behalf of small mutual fund companies and our shareholders.

Clearly, there are important ways in which Ariel and other small, entrepreneurial fund firms stand apart from the giants in our industry. Yet, because of our vision and hard work, and because of regulatory innovations like the SEC's Rule 12b–1, we are able to compete fiercely and quite often successfully with larger fund companies every single day.

A breach of trust involving mutual funds has raised doubts about my industry's commitment to integrity, a commitment that tens of thousands of mutual fund employees have spent more than 60 years building. Recent disturbing revelations have led some to conclude that fund companies are ignoring their fiduciary obligations, have lost their connection to shareholders, and have abandoned the basic principles of sound investment management. Nothing could be further from the truth. As a mutual fund company executive, I know my future, my credibility, and my livelihood are inextricably linked to that of our shareholders and their success.

First, I would like to address the issue of mutual fund fees. Federal regulation of prices can be appropriate when there are few competitors and little choice that the opportunity for monopolistic practices is a threat to the consumer. This is not the case in our industry. Notwithstanding some heated rhetoric to the contrary, mutual fund competition is powerful, vibrant, and growing. Capitalism is working and price regulation, as some have proposed, is both uncalled for and potentially disastrous.

Second, mutual funds are one of the only products I know where price increases are actually rare. To raise management fees, a majority of our fund companies' directors must vote that an increase is needed. Then a majority of the fund's independent directors must separately vote for a higher fee. After that, the ultimate decision rests with the fund's shareholders, a majority of whom must also vote in favor of any increase before it can take effect.

While some critics claim mutual funds charge higher fees than pension funds and other institutional accounts, their analysis is seriously flawed. The fact is mutual fund investors receive a litany of services not commonly offered to institutional investors. They include phone centers, websites, compliance, accounting, and legal oversight, as well as prospectuses, educational brochures, and shareholder letters.

Contrary to some claims, fund fees have declined steadily for more than 20 years. ICI research shows since 1980, the average cost of owning stock mutual funds has decreased 45 percent. Additionally, the SEC, GAO, and ICI have all concluded most mutual funds reduce fees as they grow. While one of my fellow witnesses appears to believe otherwise, it is undeniable that this is the very definition of economies of scale. Industries generally do not produce

scale economies. Companies do. If any of us wanted to start manufacturing automobiles tomorrow, the huge scale enjoyed by Ford and General Motors would be of relatively little help to us. It would still cost us a fortune to produce new cars.

Some question if mutual fund fees are understood. Fund prospectuses are required to have an SEC-designed table showing fees in place, English-based upon strict formulas. A key part of this table is the standardized example illustrating the cost of a $10,000 investment. Beyond the prospectus, the SEC recently ruled reports must illustrate the exact cost in dollars of a $1,000 investment over a 5-year period. That is in the shareholder report now. These guidelines enable investors to compare the total fees of 8,000 mutual funds competing for their business.

A significant mutual fund fee issue that has been frequently misunderstood relates to a portion of fund expenses called the 12b–1 fee. The issue is of great import to small mutual fund companies like Ariel because it impacts our ability to reach investors. The easiest way to think about mutual fund distribution is to equate it to the film industry. You can make a great movie, but if you do not have a distributor, no one will see it. Similarly, you can have a terrific fund with an excellent track record. But if the fund company does not have access to effective sources of third-party distribution, it will be a fund more in theory than in practice because it will have so few investors.

Distribution costs money. Without the means to pay for access to these far-reaching channels, the smaller fund companies that lack scale, a recognizable brand name, and huge advertising budgets will be disproportionately disadvantaged. Ultimately, mutual fund investors will have fewer and much lesser first choices. We have seen many instances where industries came to be dominated by a few large firms. Does anyone believe that is good for consumers, for competition, and for economic growth? I do not think so.

Let me now turn to fund governance. Should Congress mandate an independent chair? In my view, an across-the-board rule is unwarranted. The Chairman's status is far less relevant than a strong majority of independent directors who make all the key decisions. For example, Ariel's board has an independent chair and a majority of independent directors advised by their own independent counsel. Among other things, these members have the exclusive responsibility to renew our advisory contract each and every year. In fact, our board does not even allow us to be present in the room during their annual contract renewal discussion. So, the idea that we as inside directors are active participants in our own contract assignment and in some ways self-dealing is just not true.

Additionally, independent directors are solely represented on all board nominating committees, leaving insiders like me no say in the board's ultimate composition. Most important of all, an independent board can at any time decide its own chair.

Another governance issue of note is the SEC requirement for the hiring of a compliance officer reporting to independent directors. I understand why the SEC and the ICI have advanced this rule in response to recent abuses. But such mandates disproportionately impact smaller fund companies, seriously affecting our cost structure, as well as our ability to compete against industry giants.

Finally, regarding disclosure, I agree with Federal Reserve Chairman Greenspan who said, "In our laudable efforts to improve public disclosure, we too often appear to be mistaking more extensive disclosure for greater transparency."

Former SEC Chairman Levitt appears to share the concern. He said, "The law of unintended consequences has come into play. Our passion for full disclosure has created fact-bloated reports, and prospectuses that are more redundant than revealing."

Notwithstanding these observations, the SEC reported last June that it adopted 40 new investment company rules, including many disclosure requirements, since 1998. That is an average of one every 7 weeks. The impact of new proposals on small mutual fund companies is perhaps understandably not always at the forefront of regulators' thinking, but I urge the Committee to think about this. As some of you have suggested over the last few years, the Nation would benefit substantially from finding ways to improve our comprehension of the information already disclosed. Financial literacy is the only real way to empower investors to make the right choices that will secure their futures.

At Ariel, an inner-city Chicago public school bearing our name has an innovative saving and investment curriculum. Similarly, the ICI has developed its own financial literacy initiative. Education programs like these will help replace both confusion and fear with knowledge and confidence.

My colleagues at Ariel and so many others in the fund industry are grateful for your efforts. By effectively reinforcing investor protections and supporting the integrity of our markets, we know you are helping our business and our shareholders. That said, recent events notwithstanding, it would be deeply regrettable if attempts to heighten fund company oversight eroded the competitive position of small firms that represent the dynamic, entrepreneurial spirit of the mutual fund industry.

Again, many thanks for allowing me to testify.

Chairman SHELBY. Thank you.

Mr. Bogle.

STATEMENT OF JOHN C. BOGLE
FOUNDER AND FORMER CHIEF EXECUTIVE
VANGUARD GROUP
PRESIDENT, BOGLE FINANCIAL MARKETS
RESEARCH CENTER

Mr. BOGLE. Thank you very much, Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee. You honor me by inviting me to be with you today.

I have a unique perspective, and it is based on a 53-year career in the mutual fund field. I was inspired by an article in the December 1949 issue of *Fortune* magazine, wrote my Princeton University thesis on mutual funds, and joined Wellington Management Company in July 1951, and served with this industry leader until 1974. Then I took what you might call the road less traveled by, if I may say so, and founded Vanguard as a truly mutual mutual fund complex. It is unique.

At Vanguard we broke unprecedented ground by having our management company owned not by outside owners, but by the

shareholders of the mutual funds it managed. We called it the Vanguard experiment in mutual fund self-governance, and from the outset we have operated on an at-cost basis. Shortly after we began, we eliminated all sales charges, and we have operated as a no-load business for almost the last 30 years.

I think it is fair to say—I hope it is not self-serving to say—that the experiment seems to have worked. Our fund assets then were $1.4 billion, and they now total $725 billion. Our funds are owned by 17 million Americans. During the three decades in which the average expense ratio of the average mutual fund has risen by 50 percent—and that is the fact—our expense ratio has fallen by 60 percent. At 0.26 of 1 percent, it is fully 1.10 percentage points below the industry norm of 1.36 percent. That differential resulted in a savings to our shareholders, Vanguard shareholders, of more than $6 billion in 2003 alone. Partly and very importantly by reason of those low costs, our mutual funds have been recognized almost everywhere, if not everywhere, for earning returns that are superior to those of their peers. And our market share of industry assets has risen unremittingly, year after year after year, from 1 percent of industry assets in 1981 to 9 percent of industry assets today. Delivering maximum shareholder value, it turns out, is a winning business strategy.

Vanguard's structure was designed to honor the basic principles set forth in the Investment Company Act. Mutual funds must be "organized, operated, and managed" in the interests of their shareholders and not in the interests of their investment advisers and distributors. The Act is completely clear on that. And it says nothing, by the way, about letting the marketplace set management fees out there, nor does it say anything about charging fees that traffic can bear. It says directors have the obligation to organize in the interests of shareholders. Yet, by and large, I am sorry to say that the conduct of this industry in general has honored that principle more in the breach than in the observance.

The recent scandals have clearly reflected the serious nature of that breach, but these scandals are, in fact, gentlemen, the tip of the iceberg, reflecting the conflicts that exist between the interests of shareholders and the interests of managers. These scandals have been terrible, but the conflicts have been far more costly to investors in two other areas: One, the setting of mutual fund fees at levels that are highly profitable to managers, even as they severely erode the returns the funds deliver to investors; and, two, asset gathering has overtaken prudent management in importance, exemplified by aggressive marketing practices, the asset-gathering practices, marketing practices focused on bringing out new funds to meet each new market fad, recent technology in the new economy, and advertising our highest performing funds. Both of these actions have cost investors hundreds of billions of dollars.

This is a vastly different industry than the industry I described in that ancient Princeton thesis. Trusteeship has been superseded by asset building. Stewardship has been superseded by salesmanship. As my prepared statement makes clear, the costs imposed on fund shareholders have soared, and the returns earned by fund shareholders have tumbled. And if you do not believe that, just

look at Chart 10b—"The Stock Market, Funds, & Fund Owners" of my written testimony.

Equity mutual funds today are measurably riskier than they were then, and today picking funds is akin to picking stocks. The six-fold increase in our portfolio turnover to 110 percent a year reflects a strategy that has moved from the wisdom of long-term investing to the folly of short-term speculation. Fund managers, once almost entirely small, privately-held professional organizations—and I salute those that remain that way today—are now overwhelmingly owned by giant United States and foreign financial conglomerates, who are in this business, to state the obvious, to earn not only a high return on your capital but also a high return on their capital.

Of course, we need regulatory action to prevent a recurrence of the ethically unconscionable conduct that we have seen in the scandals, but we need something more. We need to strengthen governance so that funds put the interests of their shareholders ahead of the interests of their managers, just as the Act demands, at least for the large fund complexes. I believe that we need an independent fund chairman, a board on which the manager has no more than a single representative, an independent staff that provides the board with objective information, and an express statutory standard of fiduciary duty to assure that the funds are, indeed, organized, operated, and managed in the sole interest of their shareholders, just as the statute demands. These changes are not a panacea, make no mistake about that. But they are a beginning.

We also need statutory language that encourages directors of funds and fund complexes, once they reach a certain size, to consider moving to a mutual structure, of all things, in which shareholders, not the managers, control the funds, a structure that has served Vanguard shareholders so very well. It is a curious irony noted in the addendum to my remarks today that U.S. Senators, of all people, and all other officials and employees of the Federal Government have precisely such a program, a mutual fund group available to all of you in the Federal Employees Thrift Savings Plan, operating at a tiny cost, 7 basis points a year—even lower than Vanguard's 37 basis points for our equity funds, which has $130 billion worth of assets. In fact, the Federal plan is the 13th largest mutual fund complex, and they run it just the way we do.

Public fund investors deserve to have their funds operated under those principles, too, or at least have the opportunity to. What investors deserve, gentlemen, is fund companies that are truly of the shareholder, by the shareholder, and for the shareholder.

Thank you very much for your attention. I am looking forward to responding to your questions.

Chairman SHELBY. I want to thank all of you on the panel.

Mr. Pottruck and Mr. Bogle, I will address this question to you. There is no doubt that costs matter and that investors should have access to cost information as they make investment decisions. Many people contend that mutual fund fees are excessive and that there are insufficient market pressures and incentives for funds to minimize costs. How do you respond to this assertion? Shouldn't informed investors be able to make their own investment decisions? Mr. Pottruck, do you want to take that first?

Mr. POTTRUCK. Sure. Thank you, Chairman Shelby.

I think that we would say in the mutual fund industry that costs vary all over the board.

Chairman SHELBY. But they matter, don't they?

Mr. POTTRUCK. They certainly matter. Absolutely they matter. But investors are most motivated by the return they get net of fees. Many investors are willing to pay more to get something more than the lowest-cost fund. Sometimes that is in the performance of the fund——

Chairman SHELBY. So pay more for quality advice or for quality investment?

Mr. POTTRUCK. Sure. It is all of the above. Sometimes they pay more because they do not want to be put on hold when they call a call center, or they want a superior website. Or perhaps they want to be able to sit down and have someone explain mutual funds to them, because they have never invested before and it is a little frightening to put their money at risk when it is their retirement that they are talking about. And they need someone to walk them through the difference between a bond fund and an equity fund.

Chairman SHELBY. To most Americans, this is part of their nest egg, or whatever you want to call it, is it not?

Mr. POTTRUCK. Absolutely. It is the primary saving vehicle for most Americans who are trying to save for their retirement. So a little advice and a little counsel is often a very important part of that process.

An example is we distribute the Vanguard funds at Schwab, and we have $20 billion of our $1 trillion at Schwab has gone into the Vanguard funds. They are a terrific fund company and very, very competitive. But what is interesting is that everybody who buys the Vanguard funds at Schwab pays a little extra, pays a transaction fee, a brokerage commission, if you will, to buy the Vanguard funds. They pay more to buy the Vanguard funds from Schwab—and they know that at the point of purchase—than they would pay to go to Vanguard directly. So lowest price is not always the only thing people care about. They care about the whole range of services and things that come with the product, and you see that virtually in every industry.

Chairman SHELBY. Well, trust is an important component of all this, too, isn't it?

Mr. POTTRUCK. No question.

Chairman SHELBY. Integrity.

Mr. Bogle, do you want to comment?

Mr. BOGLE. Yes. Obviously price is extremely important, and investors, truth told, do not pay very much attention to it, partly because they chase past performance. And it is wonderful for us to say, "Wouldn't you pay a few extra percentage points for a few more points of performance?"

The problem with that analogy is that cost goes on forever and performance comes and goes. And we know by looking at the record that the low-cost quartile of funds provides a return over a decade, any decade you want to look at, that is something like 3 percentage points a year—an astonishing amount—over the high-cost quartile. And it happens in every single Morningstar style box, large cap

growth and small cap value, et cetera. But people do not pay much attention to cost. Another reason they do not is because they are much too short-term in their investment horizons. You know, a difference of 1 or 2 percentage points in return over an investment lifetime is half of your capital. When you lose 2 or 3 percentage points of return over 30 years, you have put up 100 percent of the capital, you have taken 100 percent of the risk, and you have gotten 50 percent of the return. And the intermediaries put up 0 percent of the capital, took 0 percent of the risk, and got 50 percent of the return. It is not a good deal, sir.

Chairman SHELBY. Good answer.

This next question is for all of you. Some contend that the current scandals are exposing a fundamental weakness in the structure of the fund industry. This weakness is the legal construct that each fund is a separate company with its own board. Many contend that in reality boards are totally reliant on the adviser who creates and manages the fund because boards have no independent operational authority.

Some people contend that the current fund structure should be eliminated and funds should be combined with the adviser so that funds and advisers are under the authority of one board and are accountable to one set of shareholders.

Chairman Ruder.

Mr. RUDER. I do not think there is any need to change the fundamental structure of the fund industry. We have had scandals in the industrial community, as Senator Sarbanes knows, in which the directors and officers were not doing their jobs.

The important thing is to instill into the directors the obligation to oversee the adviser and the service providers, both in terms of quality and in terms of fees. It is a hard thing to say that directors have to perform their jobs better, but we need to motivate them to do that.

Chairman SHELBY. Mr. Pottruck.

Mr. POTTRUCK. I would agree with Mr. Ruder. I do not think we have to dismantle the governance structure of mutual funds. Effectively, the single shareholder proposal is more like some of the other products that are already offered in the investment industry, separate accounts and such. Mutual funds have stood the test of time. They have made investing in equity markets and participation in the capital formation of America a possibility for millions of Americans who otherwise could not in any way participate.

I think that while it is easy to look at the recent scandals and think that the whole mutual fund industry does not work, I would argue that there is so much more good than bad. We should focus on the kinds of things that would prevent future problems. Shame on us if we allow those things to continue to happen or happen again. But I would urge the Committee to consider the broad range of what mutual funds have accomplished for America. More Americans are participating in capital formation and in the power of capitalism than ever before.

Chairman SHELBY. Ms. Hobson.

Ms. HOBSON. I do not necessarily see, in thinking through how our board meetings actually work in the structure of our firm, what that would change. At the end of the day, this wholesale change

to consolidate the fund company and the adviser and the fund to me seems, again, like it sounds good in theory, but in practice nothing would be different. And the reason that I say that is that when I think about who we are accountable to every single day, we know we are accountable to those shareholders, and we know that the board at any time can just——

Chairman SHELBY. But haven't some people forgotten that in the industry?

Ms. HOBSON. I think that some people, in terms of how they have treated their shareholders, have put themselves first. But I do not think that that is everyone in the industry.

Chairman SHELBY. I agree with you. Mr. Bogle.

Mr. BOGLE. Believe it or not, I would not require the compulsory mutualization of the entire mutual fund industry. I do believe this: We need a governance structure that puts funds in a position to do that, if funds reach a size where that is a feasible option. You know, if everyone had that kind of a structure, there would be no entrepreneurship in the business. There may be too much of it now, but every business needs some of it. New funds would not be started, and the established firms would be dug in and we would have an oligopoly situation. However, I do not think that is healthy for anybody.

But we need to put directors in the position where they can mutualize once the funds reach a certain size and standing. It would not apply to small funds. The example I like to use is when a fund is born, of course it needs a parent. When the fund gets to 21 years old and $100 billion of assets, maybe it can strike out on its own and make its own decisions in its own best interest. And, my gosh, the oldest fund is 80 now. It really must be time for them to think about it. That is pretty old for not being able to make any decisions of your own.

I do think that that structure can best be done not only by the governance changes I have suggested, giving some heft to the weight of the fund board and the fund operation on the decision, but I also believe that would be substantially enhanced—and this is exactly, by the way, the way Vanguard began; we did not begin as a full-fledged mutual fund complex—by having the funds take over operational control over the things that we do not usually associate with advisers, like the administration, the shareholder recordkeeping, the legal compliance. All of those would be fund functions under this structure, and the adviser would provide advice and the distributor would provide distribution. And if you had that structure, then the funds could say to the adviser we think we should do a little fee negotiation here. You have gotten big. Let's talk about it. Or we think maybe we should use a different distributor instead of you. Or maybe the fund manager has failed, and we say we are going to bring in another manager.

We do that at Vanguard, not frequently—but more frequently than we would like because we hope to hire a manager forever. But that sometimes does not work out.

We have the flexibility to deal with the funds' managers on an arm's-length basis. So, I think in that little scenario lies the ingredients for a much better industry.

Chairman SHELBY. Senator Bayh.

COMMENTS OF SENATOR EVAN BAYH

Senator BAYH. Thank you, Mr. Chairman.

First of all, I would like to thank all of our panelists for being here today. We very much appreciate your time.

Mr. Bogle, you—and I apologize, Mr. Ruder, I was not able to be present for your testimony—describe a situation in which market imperfections keep what some of the other panelists have described as the normal competitive forces from working in the best interests of shareholders. Why, in your opinion, does the competitive marketplace not function as it should in this context?

Mr. BOGLE. I think that part of the answer is investors are very unaware of the importance of independent representation, very unaware of the importance of cost, and all too aware of how the fund did yesterday, last week, month, and year. Also do not forget that the mutual fund industry, like the life insurance industry, spends huge amounts of its resources on marketing and distribution. In other words, this is a sales-driven industry and not a buyer-driven industry. The selling power is what basically drives most of this industry, what the brokers are selling, what the advisers are selling. So those things are an important part of it.

But the reason it should not be that way is we have a fiduciary duty. It is established in the common law going back, I guess, thousands of years. It says that funds are different. Other people's money is a sacred trust that requires a fiduciary duty of those who are overseeing it. And it is that we have moved too far away from this idea—not entirely away from in all firms, but too far away in too many firms.

Senator BAYH. So in your view, it is the retrospective view of investors and focusing on that rather than costs, which, to use, I think, your phrase, you said costs are perpetual but performance varies. Is that in a nutshell? And I would like to give Ms. Hobson and Mr. Pottruck——

Mr. BOGLE. Well, just let me add one thing quickly to that, and that is what I said, but I do not want to understate the tremendous power of a sales force. I mean, that is the way the life insurance industry got the way it is.

Senator BAYH. Mr. Pottruck and Ms. Hobson, would you like to respond to that? Why, in your view, do the market imperfections that Mr. Bogle focuses on not exist?

Ms. HOBSON. One thing is that there is competition. This is very important. It is probably the most important theme that I could stress. There are 500 mutual fund companies, 8,000 choices. People can select from a wide, broad range, and the market in basic capitalist terms, what we learn in economics in school, allows the customer to make their own choice, and it bears—there is supply and demand there. Where there is demand, people go. People vote with their feet in this business, and it is very interesting that Mr. Bogle talked specifically about how the funds get marketed and the cost. But at the end of the day, the investors are buying the lower-cost mutual funds. That is one of the reasons Vanguard has been so successful, as well as lots of other mutual fund companies around this country.

This idea that sales and marketing become a four-letter word, a bad thing, is something I just absolutely reject, because when you

are a small mutual fund company, you have to do everything you can to think of ways to sell and market when the top 10 mutual fund companies in this country, of the $7 trillion in assets, control $3 trillion of them, spend lots of money in advertising, lots of money in promotion. So sales and marketing is very important.

Senator BAYH. Forgive me for interrupting, Ms. Hobson, but in your view, consumers have access to adequate information to make informed decisions?

Ms. HOBSON. I certainly believe that there is a lot of information that consumers are hit with, and the question is: Is there a way this information can be given to them so they can understand it?

I talked about my role on TV and the types of questions that I get there. The question is not that there is too little information. It is that it is too much. Tell me what is important because I am trying to sift through too much and I cannot understand.

Senator BAYH. Well, that gets to the advisory component that Mr. Pottruck was referring to. To both of you, again, Mr. Bogle referred to the fiduciary duty component of this. Let me ask you for your response about what appears to be a tradeoff between—with so many members of boards serving the whole family of mutual funds, and I gather the argument is that that in itself creates efficiencies for the shareholders. But at some point you reach a tipping point at which you serve on so many boards, it is more efficient, but doesn't it also create some difficulty in adequately overseeing—carrying out your fiduciary duty? Do you have a response to that criticism that has been raised? I think one fund family has a director serving on as many as 277 boards. How is it possible to exert effective oversight on that many funds?

Ms. HOBSON. In our situation, we have four mutual funds and our directors serve on all four, and I see a lot of benefit to them being there for the discussion of all four mutual funds and the issues that are affected. I also see a benefit to the funds splitting the cost of flying them to Chicago and dealing with all the expenses that relate to them. I think that is something that is important.

Also when I think about just the logistics—if you have a mutual fund company that has several hundred mutual funds, and you have four to six to eight board meetings a year, and you start to break apart the number of funds that one director can serve on, you would be having mutual fund board meetings every single day. That is what the company would be in the business of doing.

So, there is to me some realistic number that is right that will allow for the efficiencies and at the same time allow people to run a business and not spend all of their time in board meetings. I do not know how you do that if you limit that fund company to two or three boards. You know, when you think about how many directors they are going to need and how many mutual fund board meetings they are going to have, it will be——

Senator BAYH. Well, four certainly is reasonable. I would say to the layman when you get up to 277, you do kind of wonder, you know, how is that possible?

COMMENTS OF SENATOR PAUL S. SARBANES

Senator SARBANES. Do you think 277 is too many?

Ms. HOBSON. I do not know how they run their structure, so it would be impossible for me to comment.

Senator SARBANES. No matter how they run their structure, is it too many?

Ms. HOBSON. If they have board meetings for a week, is it reasonable to think that you could cover 277 boards if you were working from 9 to 5, over 5 days, six or eight times a year——

Senator SARBANES. Is that reasonable?

Ms. HOBSON. It is possible, sure.

Senator SARBANES. Forty-five hours for 277 boards?

Ms. HOBSON. It is absolutely possible.

Senator SARBANES. Do you think that is reasonable?

Ms. HOBSON. The thing is, you would have to look at the board.

Senator SARBANES. I took your figures, 9 to 5, 5 days a week—actually that is 40 hours, not 45 hours, for 277 funds. So is that reasonable?

Ms. HOBSON. I think that it depends on the boards and it depends on the type of funds. If you had a hundred index funds on that list out of 277, there is not going to be a lot of detail that you are going to get into on performance, which is a big part of the board meeting. So, it is impossible for me to answer that question without having a better sense of the actual funds that are being overseen.

Senator SARBANES. That is 14 minutes a fund.

[Laughter.]

Ms. HOBSON. But the thing is that a lot of the discussion is in common, so you are going to have a discussion about distribution, compliance, and legal issues that is going to happen across all of those funds, and then there will be independent discussions about the actual fund performance itself.

Senator BAYH. I see my time has expired. Thank you, Mr. Chairman. Again, thanks to our witnesses for your testimony today.

Chairman SHELBY. Senator Sununu.

COMMENTS OF SENATOR JOHN E. SUNUNU

Senator SUNUNU. Thank you, Mr. Chairman.

I think that was a great answer. You talked, Ms. Hobson, about information and that there is a concern perhaps among some consumers that they have a lot of information, but maybe it is too much, maybe it is not quite the right information, maybe they do not know what to do with that information. Are there any specific ideas that are out there that you have come up with, that you have heard the SEC discussing that might help improve transparency for investors, help clarify the information, help improve the disclosure rules that we have?

Ms. HOBSON. I think there are a number of things that I have seen suggested, I have heard the ICI talk about, and some of your colleagues mention. I think issues related to portfolio turnover, prominent discussions of that will capture some of the issues that are very hard to define around transaction costs, since there is no agreed-upon methodology there.

Some of the discussion about the $10,000 example that the SEC has imposed now in the shareholder letter is not a bad thing. That shows the expense ratio and the actual cost that you will pay. I

think that that is very good. People, if they do not read their prospectus, maybe they would catch that information in their shareholder letter.

I think that the issue is: Can we be smarter about all of this thick document that we are giving shareholders? We have gone to the plain-English prospectus a few years ago that I think helps a lot, not having the legalese. And I am sure we could be more creative about some of these other ideas that would help investors.

Certainly some of the new advertising rules are very, very good, where the standardized periods, the performance discussion, after-tax I think is very good. So there is information there that is helping the investor get a clearer view of what they are paying.

Senator SUNUNU. So, Mr. Bogle, you talked about the predicted performance of costs. Low-cost funds historically have performed better than high-cost funds. That seems to me to be a strong argument for good transparency, good disclosure, along the lines just described by Ms. Hobson, maybe some of the other proposals that are out there. Do you also, however, advocate a capping or Government regulation of those fees?

Mr. BOGLE. No, I do not.

Senator SUNUNU. You do not. Excellent.

Mr. Ruder, you talked about the proposal for independent board members and for a disinterested chairman. I think it was yesterday, it may have been the day before that we had a hearing—we have had a number of important hearings in this Committee—but we had a hearing where specific studies were referenced that showed no correlation between having a disinterested chairman and the quality, the overall performance of the company, or the overall performance of a mutual fund. What is the purpose of proposing a standard mandate or requirement that every fund have a disinterested chairman?

Mr. RUDER. In most cases, when the fund board meets, the adviser presents the agenda. The adviser, with its own chairman, will run the meeting and will have control of the meeting. That is a situation which does not allow the independent directors to act in a forceful manner.

We have a situation now in which, within the last 3 years, the SEC has required that the independent directors be a majority of the fund boards. And we are only moving into a situation where these directors are going to have to fulfill their responsibilities, and I think that directors are going to be much more able to fulfill their responsibilities if they have power. If you allow an adviser to be the chairman, he can cut off discussion, he can control the agenda, and he can force his or her attitudes on the independent directors. I think that is wrong.

Senator SUNUNU. If, in fact, the board structure you describe resulted in limitation on directors from being able to fulfill their responsibilities or act as they should—your words—or their ability to make good decisions, would not an evaluation of 50 or 100 or 1,000 boards be able to identify that that board structure results in poor performance, bad decisionmaking or, in the case of recent history, the scandals that we have read about being correlated to the lack of an independent chairman?

Mr. RUDER. I know of no studies which have reached that conclusion. On the other hand, I do not believe there have been very many studies about this topic. What I am talking about is essentially a sea change in the way the boards work. I think that our investors need to have the opportunity to see what will happen in this industry if we have a responsible governance mechanism.

Senator SUNUNU. I will certainly submit for the record that the study that was described in the hearings earlier this week was an evaluation of approximately 1,000 different public companies, certainly not all of them financial services or mutual fund related, but fortunately or unfortunately, there wasn't a correlation shown. I have no opposition to boards having independent chairmen.

Ms. Hobson has an independent chairman, correct? I am sure it is a perfectly effective and workable structure, and there are some independent chairs and independent board members that I think do an outstanding job. There are others, as was also testified to at the hearing, that have a great deal of trouble staying awake in the meetings.

I think it is pretty clear which ones you would want to have on your board, but it is also clear that the fact that they carry the label "independent" does not necessarily mean that they are delivering a superior level of oversight, decisionmaking, or responsibility on behalf of mutual fund investors or shareholders.

Thank you, Mr. Chairman.

Chairman SHELBY. Senator Sarbanes.

Senator SARBANES. Thank you very much, Mr. Chairman.

First of all, I want to express my appreciation to the panel, not only for their oral presentations, but also for their written statements. Obviously, a lot of work and effort have gone into them.

Mr. Chairman, I would be remiss if I did not, at the outset, thank David Ruder for his contributions when we were working on the corporate governance and accounting oversight issue. Mr. Ruder was on the initial lead-off panel when we had the five former Chairmen of the SEC. We received absolutely splendid testimony from all, extremely thoughtful, knowledgeable testimony, from all five Chairmen. And Mr. Ruder, in subsequent weeks, was of help in counsel to the Committee, and I want to express my appreciation.

Mr. RUDER. Thank you, Senator.

Chairman SHELBY. If I may interject, that was unprecedented when you were chairing the Committee, and we had five, including you, Chairman Ruder, former Chairmen of the Securities and Exchange Commission, all of which had spent months collectively in this Committee all in one panel. I commend you for that.

Mr. RUDER. I found them to be very opinionated, aggressive, and wonderful.

Chairman SHELBY. Quite opinionated, but wonderful too.

Senator SARBANES. Ms. Hobson, I have been looking at your statement, and maybe I missed it, but I am trying to find what changes, if any, you think should be made. A quick reading of your statement would lead me to the conclusion that you do not really think anything should be changed. Am I right in that impression?

Ms. HOBSON. No, you are not right in that impression.

Senator SARBANES. Now did I miss it in your statement or is it not here?

Ms. HOBSON. No, in my statement, I really wanted to focus on some of the possible repercussions to the changes that are being suggested for small mutual fund companies and ask——

Senator SARBANES. I think it would have been helpful to us if you had also focused on what changes we might consider as being necessary, since most people seem to think some changes are necessary. I know Mr. Pottruck has a section outlining some changes that he thinks should be made.

Ms. HOBSON. I would be happy to comment on those changes in writing to you that I think are appropriate. One of them that I think is terrific that has been suggested is no longer allowing directed brokerage for the selling of mutual funds. I think that makes a lot of sense and eliminates conflicts of interest at the brokerage level. That would be one simple one I could point to very quickly.

I think the two-thirds majority board that the SEC adopted was a good idea. We already had that, but again I recommended and stated that I thought a strong independent board was the most important thing that could be done to offset some of the problems that have existed. So those would just be two of them.

Senator SARBANES. Why don't you submit something to us in writing. It would be helpful——

Ms. HOBSON. Sure, I would be happy to do that. Thank you.

Senator SARBANES. It would be helpful to us in our deliberations.

Mr. Pottruck, *Fortune* magazine, dated December 8, 2003, contained an article, "When Bad Things Happen to Good Companies," and this is what the article says: "When WorldCom blew up, Pottruck had a fit. 'How could this be? Where the hell are the goddamn accountants? How could the board of directors and the auditors let this happen? I just could not believe it.'" That is the end of the quote from the article. Now, how accurate they are in quoting you, I do not know. I am just quoting the article.

Since then, starting in September of 2003, with Attorney General Spitzer's case against Canary Fund, a series of scandals have rocked the mutual fund industry. In your view, how could the board of directors let this happen? And to use your words, I could not believe it when I heard it, but there we are.

Mr. POTTRUCK. I think what we have learned is that there are lots of opportunities in an industry made up of tens of thousands of people for individual acts of failure to happen that can go undetected when they are as subtle as they sometimes are. We in the mutual fund industry, in many cases, never even conceived of some of the problems and practices that we have now learned were going on. So this has been an eye-opener, an embarrassing eye-opener to our entire industry.

In many, many cases boards rely on management to fulfill fiduciary responsibilities, and I believe that management makes every effort to do that. But sometimes individual acts of compromised behavior, where people are not fulfilling their legal and fiduciary responsibilities, can go undetected if you do not have sufficient oversight detection.

Senator SARBANES. Who should do the oversight detection?

Mr. POTTRUCK. Sometimes it is beyond the capability of a fund company to do it for themselves, and they have to outsource it to another firm who might have the technology. They might have to rent somebody's computer technology to do the artificial intelligence kind of work that detects patterns of behavior or other signals that indicate that more investigation needs to happen.

We are trying to look at the thousands of transactions that go on and see if there are patterns that suggest some kind of abuse. Then we send people in to investigate whether something real is going on here that we should be concerned about. But ultimately management owns the responsibility and the accountability to make sure that those kinds of things are happening.

Senator SARBANES. Are you supportive of compliance officers and strengthening that whole concept in order to have that watchdog at work?

Mr. POTTRUCK. I think the idea of having a chief compliance officer who reports to the board is not very different than public companies having a head of audit who has a reporting responsibility to the audit committee. So, I am supportive of that idea.

Ms. HOBSON. If I could just add one thing, Senator?

Senator SARBANES. Yes, you don't like that idea, as I understand your statement.

Ms. HOBSON. I am concerned about the cost. So if the small fund company has to bear the cost, does it create a scenario where they cannot compete in the same way as the big fund companies. If you are a Fidelity and you have a floor full of lawyers, and you are Ariel and you have two, does that change the game for you when you are then being told you have to bring someone in? And then, of course, the price of those people will be very clearly set by the demand that we will all have at the exact same time for those individuals.

Senator SARBANES. If there are abuses going on, and if a compliance officer is adjudged would be of use in curbing those abuses, should we forgo that change because the smaller funds present the position that there is a cost inherent in the compliance officer?

Ms. HOBSON. I guess the answer would be, from my perspective, that we want to do anything that will make our industry better, and if it costs money, and it makes sense, and it can prevent abuses and make us better, we want to do it. But this is the issue that I think is hard.

When we were thinking about all of the scandals and how they unfolded, I remember one day waking up, when I read the stories about portfolio managers timing their own funds, and I said to the chairman of our firm, not the board chairman, but the chairman of our company: How would we have known to catch this? How would we have figured this out? Even with the best of intentions, trying to run our business in the best possible way, would I have thought about looking at the transactions of our employees on the mutual funds when that, in terms of our personal securities reporting, is an exempted category by the SEC? We report the stock trades that our individual employees make, but we never had them report their mutual fund trades.

Well, that was, with best of intentions, I would not have thought of it. Now, you better believe, after the story broke, I said, "I want

to see everyone's trades for the past 5 years, every single quarter, every trade and double check and see if there was anything there." And with some pleasure, I was glad to see that we did not have any problem.

But running the company as effectively as I can think of, and trying to put the shareholder first, I would not have had a way to think about some junior analyst that maybe was timing our fund, nor would there have been a policy for it.

Chairman SHELBY. Ms. Hobson, what size firm do you have? You say you are a small mutual fund. What are you managing?

Ms. HOBSON. In mutual fund assets, we manage $5.5 billion, and then we have——

Chairman SHELBY. What is Charles Schwab managing, Mr. Pottruck?

Mr. POTTRUCK. We manage approximately $280 billion in mutual fund assets.

Chairman SHELBY. So $280 billion compared to that.

Mr. POTTRUCK. Right.

Chairman SHELBY. Mr. Bogle, what is Vanguard managing now?

Mr. BOGLE. Well, $725 billion.

Chairman SHELBY. Okay, $725 billion.

So, she is making the point, although $5 billion is a lot of money to several of us up here, it is not a lot of money compared to the giants in the mutual fund industry; is that your point, Ms. Hobson?

Ms. HOBSON. That is my point, but also the point that I was trying to make is, if we do hire the compliance officer, we then need to——

Chairman SHELBY. Sure, I see your point.

Ms. HOBSON. How will we know that they can check in a way that is even more effective than what is being done, when some of these things, you just cannot even contemplate?

Senator SARBANES. Well, I think—if I could just close, Mr. Chairman—that the industry needs to come to grips with this challenge.

In March 2003, the Chairman of the ICI, testifying before the House Financial Services Committee said, "The strict regulation that implements these objectives has allowed the industry to garner and maintain the confidence of investors and also has kept the industry free of the types of problems that have surfaced in other businesses in the recent past. An examination of several of the regulatory measures that have been adopted or under consideration to address problems that led to the massive corporate and accounting scandals of the past few years provides a strong endorsement for the system under which mutual funds already operate."

In effect, we took that and gave credibility to it. Then, subsequently, beginning last fall, we see the unfolding of all of these problems. Now, you know, it came I think, in effect, as something as a surprise to a lot of people, and it seems to me at this point we need to address what can we do to bring about changes in the workings of the system that would make it less likely that these abuses would occur. The SEC is working at it, of course, and they have a prime responsibility in that area, and I recognize that, but of course at the same time we are holding these sets of hearings and trying to see what the lay of the landscape is. But I do not

think we can just let things go on as they had gone on before, before we had experienced these problems.

Chairman SHELBY. Plus, it affects about 100 million people and $7 trillion in money—$7 trillion.

Senator Allard, we thank you for your indulgence. You take what time you want.

COMMENTS OF SENATOR WAYNE ALLARD

Senator ALLARD. Thank you, Mr. Chairman. This is a very interesting hearing. I can take all of the time I want?

Chairman SHELBY. Whatever you want.

[Laughter.]

But we think you will be judicious.

Senator ALLARD. I had better be careful here. I will try and use discretion with the Chairman's generosity.

Let's suppose that I am an American that picked up $10,000, and I am trying to decide where I want to invest this money. Why would I invest in a mutual fund? Maybe in just 1 or 2 minutes, a couple or three of you can give me some good reasons why I would want to invest in a mutual fund.

Mr. BOGLE. The reason you invest in a mutual fund of any kind, and this is a very diverse industry, as we have stock funds, bond funds, and money market funds, but the reason you invest in a mutual fund is, at their best—at their best—they give you broad diversification, very consistent investment policies, and very low costs. So it gives you a chance to capture the returns of American industry, to own the stock market, if you will, for your lifetime. Whatever returns American business gives, you will share in. And if you do it at low enough cost, you will get almost 100 percent of that return, whether it is the stock market or the bond market.

Where this industry messes it up is giving you such costs that it, over 30 or 40 years as a long-term investor, you do not have a fighting chance, truth told. Our average portfolio manager only lasts for 5 years. So mutual funds, in their great diversity, give you opportunities which are there for the taking, but we have complicated it all a lot. But it is the best way to buy stocks, it is the best way to buy bonds, and it is the best way to buy money market instruments.

Ms. HOBSON. If I could add, you also get low barriers to entry.

Senator ALLARD. You get what?

Ms. HOBSON. Low barriers to entry. So, you can invest at Ariel for no minimum investment, as long as you agree to invest $50 a month. You cannot necessarily do that and go and buy General Motors stock in that way, and so you get that opportunity.

I do think you get low costs. You get professional money management. You are not trying to figure out what individual stock or bond to buy on your own. And then last, but not least, you get simplicity, and simplicity meaning that you get your tax statements prepared for you at the end of the year, you get a statement showing how your investments have done every quarter, and you get confirmations on your investments when you make them.

Those things are all very, very helpful to the investor in managing their financial life and their account, not to mention, of course, Mr. Bogle's point about diversification is very important. You are

not putting all of your eggs in one basket, so if one stock is down and another is up, you have averaged out a better return.

Mr. POTTRUCK. I would certainly agree with what Mr. Bogle and Ms. Hobson have said, but let me offer a little bit broader perspective, if I may. First of all, if you have this $10,000, and you are not a reader of financial publications and a watcher of CNBC, you might take that $10,000 and stick it in a CD or a money market fund because you do not fully understand how the stock market works, and you do not have someone who is helping you. So for many Americans, one reason to go into mutual funds is to be able to rely upon someone who helps them understand investing and reassures them of the long-term paybacks of participating in capitalism with some of their nest egg.

Another reason to invest in mutual funds is that it really is an easy thing to do. You could go to a firm like ours, which offers more than 4,000 funds, use our website and scan down the array of choices. You can screen for funds with certain levels of performance, or that have low fees, or by many other parameters. There are many different ways to participate in this industry, which is part of what makes it so vibrant and successful.

Senator ALLARD. Now, you have all given me a sales job. Where do I go now to check on what you told me? You have this capability of catering to the uninformed investor. You may be an investor who does not want to take the time to study or maybe he says, well, great, I do not understand all of these individual funds, and I like to spread my risk out. That all makes sense. Where can I go to confirm what you just told me is legitimate? Where can I check on you and confirm that they told me this. Now, can I check on performance and compare that to other companies? Where can I go for that information.

Mr. POTTRUCK. There is considerable reporting on the mutual fund industry. There are quarterly publications that show the performance of all mutual funds in newspapers——

Senator ALLARD. So, I have to buy quarterly magazines on the mutual funds or——

Mr. POTTRUCK. You get monthly statements, you get quarterly statements, which provide performance updates.

Senator ALLARD. I get that from individual mutual fund companies, but where can I go to get a comparison? Is there anywhere I can go as a consumer and get a comparison, maybe someplace on the Internet. Is there an agency out there that can give us the oversight that we need and do a comparison? Where do we go?

Mr. BOGLE. You could go to the library and get *Morningstar Mutual Funds*. They have a full page on every mutual fund practically in the business, every one of any serious size. It tells you more really than you want to know or need to know. It is presented in an attractive format. It makes recommendations. Alas, however, Senator, I have to inform you that all of these choices we give investors basically have put us in the same position as selling stocks.

There is a big risk in buying an individual stock, and we now have such a diversity of mutual funds in this industry, doing all of these very odd things, that offer nowhere near the full diversification of owning the whole stock market, and so there is a pre-

mium on choosing the right mutual funds, the right objectives, the right costs, the right sales charges, the right managements.

We have made what should be a nice simple game, where the typical investor can just go on in and do what he wants to do, into a very complicated one involving complicated choices that are made almost always on the basis of past performance, which, alas, does not repeat itself.

Senator ALLARD. So disclosure is important.

Mr. BOGLE. Disclosure is very important.

Senator ALLARD. And that leads to my next question. So if disclosure is very important, what are the key things in disclosure that would be most helpful for the consumer—disclosure of the various costs in the funds by disclosure of the dollar breakdown of costs in the purchase of the funds; or what is the percentage of return on their investment based on what kind of funds they are investing in? These are all things that get discussed in regard to disclosure. Is it appropriate to go ahead and have full disclosure? Is it appropriate for the Federal Government to insist that we have this full disclosure or are there some areas that are proper?

I happen to be someone that feels like we need to invest, and that we have to disclose necessary information for the consumer to make informed decisions. I want to know what kind of disclosure that requires.

Mr. RUDER. Sir, you should know that the Securities and Exchange Commission has over the years tried to increase the amount of disclosure which the mutual funds are making. It has greatly increased that amount of disclosure, and continues to do so.

My experience was that that increase in disclosure was quite frequently resisted by the industry, and I think it is not a good thing that they did that. I think that the industry should be telling us what kinds of disclosure should be made, and the Commission should continue to try to increase the kinds and amounts of disclosures, and to have it be done in a very understandable way.

Senator ALLARD. Why would they want to resist disclosure?

Mr. RUDER. I have never understood exactly why. They talk about costs, for one thing. I know that. There is a proposal out now that each individual be given an exact dollar-for-dollar discussion of what happened to his or her individual account. That proposal is being resisted by the industry on the grounds that it will cost a lot of money.

Mr. POTTRUCK. That is correct.

Senator ALLARD. So there is a cost with disclosure, but then Ms. Hobson also said, “You know, I would never have dreamed of doing this in my company, but I find out some other company got caught doing this, and so I checked back with my company to make sure we were not doing it.” Does disclosure not help the whole industry so you all know what is going on? And what is the right balance?

Mr. POTTRUCK. I think that disclosure can help, and it can hurt. I mean, there is probably not a person in this room who has not refinanced their mortgage in the last 2 or 3 years and signed 50 documents without having the time to read any of them.

Senator ALLARD. That sounds like closing——

Mr. POTTRUCK. That is disclosure run amuck. The design of disclosure has to be done in a way that balances the importance of

a few things being very visible with other things being available and somewhere findable so the press, and analysts, and others can hold the industry accountable. That works very well.

At the point of purchase, there are only a few things the investor needs to know. There is probably more they want to see on their monthly or quarterly statements, more still that should be in a prospectus. There is a tremendous amount written about the mutual fund industry, and the press plays an important role in giving bad publicity to those funds that are doing a very bad job for consumers, and money follows that information.

Chairman SHELBY. They should play that role.

Mr. POTTRUCK. Exactly.

Senator ALLARD. Are they doing that now?

Mr. POTTRUCK. Yes, absolutely they are. Absolutely they are.

Mr. BOGLE. Information is really a tricky thing in our business because the markets are so efficient that it is very hard to gain an edge, and in the long run, buying individual stocks is a loser's game compared to the market itself, as is buying individual mutual funds. You cannot beat the market. It is nearly impossible over time. Look at the record.

Then you look at what is being disclosed and look at, say, *Money* magazine, and what they give you here are the 100 best mutual funds. They have been giving this list for 5 years, and I will bet there are not 30 funds in this most recent list that were in the first list.

So, you are supposed to be buying each year on the basis of that? It does not make any sense. We should work much harder on simplifying and giving more diversification. This is an asset-gathering business. The reason is that is what the asset managers do. They want to get more assets and get more fees, and that is not illegitimate, except it does not help the shareholders. It says create this kind of a fund when everybody wants to buy it, so that money will come in and add to our management fees.

It has taken this nice, simple business of owning America and holding it forever, and turned it into this complex thing where we need these reams of disclosure, and I am not sure it is going to be productive. We turn over our portfolios at 100 percent a year. People want information, but I don't know what they conclude from it.

Senator ALLARD. Thank you, Mr. Chairman.

Chairman SHELBY. It sounds like I would buy the 500 index fund from what you have just said.

Mr. BOGLE. Well, I think there are worse recommendations, sir.

Chairman SHELBY. I know it. I agree with you.

Mr. Bogle, you founded Vanguard probably with a little money, and I do not know how much, not probably millions or billions, but now your firm, Vanguard, has over $700 billion; is that correct?

Mr. BOGLE. Yes, sir.

Chairman SHELBY. You are the second-largest fund at this moment, is this correct?

Mr. BOGLE. Yes, sir.

Chairman SHELBY. Gosh, we would like to have that money to close the deficit, wouldn't we.

[Laughter.]

Mr. BOGLE. Our shareholders would be reluctant to part with it.

Chairman SHELBY. We would, but we do know better than that, don't we?

Senator ALLARD. The Government is not a good investment.

Chairman SHELBY. Yes, the shareholders would revolt.

Mr. Bogle, some contend that it is inappropriate for a portfolio manager to simultaneously manage both institutional accounts, like hedge funds and a mutual fund, because the manager will favor the hedge fund at the expense of the mutual fund. What is your perspective on this and has the side-by-side management of hedge funds and mutual funds been at the center of any of the recent fund scandals? Further, how would a ban on side-by-side management impact, if at all, the mutual fund industry?

Mr. BOGLE. Those are very, very good questions and very, very tough questions. It is hard to see that the financial incentives in favor of running hedge funds are not so overpoweringly large, relative to the fees in running mutual funds, even the high fees in running mutual funds, for that matter, that the temptation to put the best ideas in the hedge fund would be very strong, not necessarily irresistible, but very strong.

Chairman SHELBY. There is a lot of temptation.

Mr. BOGLE. There is a lot of temptation.

In general, mutual funds, particularly the large fund complexes, do not run hedge funds, and I think it is the kind of split that one should think long and hard about. We need to think about what kind of regulations might reduce that conflict, and realize that one of the unfortunate, unintended consequences of such a law would likely be that every hedge fund manager who ran a mutual fund would give up the mutual fund business, and therefore his clients would have to find other funds.

So, I do not like the idea of conflicts of interest in this business, but I think we should be a little clearer about what we are giving up when we eliminate them.

Chairman SHELBY. Senator Sarbanes.

Senator SARBANES. I want to follow up on Chairman Shelby's question. When you start out on these hearings you start receiving communications from everywhere, so to speak. We received a communication that came in that said the following. I want to quote it to you and ask for comment.

> Many asset management firms have started hedge funds in the last few years due to the much higher fees and less stringent regulations, but run them side-by-side with mutual funds. They are often even run by the same portfolio managers. The main reason mutual funds firms start hedge funds is to keep star portfolio managers from leaving to set up their own fund. Some of the biggest mutual funds companies in the country are doing this. This presents incredible conflicts. Some firms have been known to short a stock in the hedge fund, hold onto it in the mutual funds because they are not allowed to sell short, and then sell the mutual funds position at a later date, thus causing downward pressure on the stock price and making the short position more valuable.

If that kind of thing is going on, as it is asserted here, do we not need to do something about it?

Mr. BOGLE. Absolutely. That is shocking, I would say. I am not an attorney, but I would say that is almost criminal behavior.

Senator SARBANES. We need to prosecute those people.

Mr. BOGLE. Yes. Just to make the record clear, we do not run any hedge funds at Vanguard. I have to say, maybe editorialize it

a little bit, that this business about star managers is a little bit odd. I have seen a lot of these stars come and I have seen a lot of these stars go, and it occurs to me that there are far more comets that burn themselves out than there are stars in the mutual fund business—think of portfolio managers that have really been good over 25 years, and we can all name Warren Buffett, and we can all name—well, there is somebody else out there I am sure. I just cannot think of another top portfolio manager for 25 years. They do not come to mind, so it is a short-term game, and that is another thing we should try and get away from.

I think it is disgraceful if what you describe is going on, but I have no knowledge that it goes on anywhere, however.

Chairman SHELBY. Chairman Ruder, we know you are an attorney, but would you describe the fiduciary duties that a fund board owes to the shareholders? Would you describe the fiduciary duties that a fund board owes to the shareholders?

Mr. RUDER. Most of the fund boards are organized either as a corporation or as trust, and the fund board shareholders or trustees owe obligations to be loyal, to act with care——

Chairman SHELBY. Honest.

Mr. RUDER. And to be honest. These are duties which occur in all organizations, but to me, to call these fiduciary duties does not nearly describe the obligations of these directors. I think in the mutual fund industry today the directors have to be alert, aggressive, and informed, and they should assume their responsibilities in a way that befits their special responsibilities. I think their obligations are greater than they are in a normal company when management is reporting to the board on a regular basis.

Here we have a separation of the directors from the adviser. You can call these duties fiduciary if you want, but these are duties and obligations that the directors need to perform in special ways.

Chairman SHELBY. Is not integrity central to the running of a mutual funds industry or to any business, but especially one that is so important to our capital markets involving $7 trillion?

Mr. RUDER. I could not agree with you more, Senator, that the concept of integrity is vital. To my mind the problem with these scandals has been at the adviser level, where the levels of integrity have not been as great as they should have been. The SEC is trying to develop a system in which the advisers can be controlled to make sure that they act properly.

Chairman SHELBY. It was mentioned earlier about a sales-driven industry, but I do not know how you take marketing out of a market driven economy, whether it is mutual funds or anything else. It is just part and parcel.

With that in mind, Mr. Pottruck and Ms. Hobson, this question I will address to you two. Broker-dealers play a large role in the distribution and sale of fund products. Could you describe how 12b–1 fees and revenue sharing arrangements are currently used and how these practices benefit fund shareholders? Also, do we need to reassess these practices in light of recent revelations?

Mr. Pottruck.

Mr. POTTRUCK. Sure. The 12b–1 fees in many cases are used to reimburse distributors for the time and energy spent talking to

shareholders or potential shareholders in explaining the pluses and minuses.

Chairman SHELBY. It is part of the marketing, is it not?

Mr. POTTRUCK. Correct, it is part of the marketing and the service. When you come to Schwab, the people who talk to clients have no financial interest in which investment choice the client makes. So, they are just trying to help find out what the client wants, what their tolerance for risk looks like. There are many different kinds of mutual funds, and this conversation can take some time. For example, there are mutual funds that have underperformed the stock market over the years, but have been exceptional performers in down markets. They lose less during down markets and they make less during up markets. Maybe over time they might underperform, but some investors want the stability during a downturn.

Chairman SHELBY. Are those bond funds?

Mr. POTTRUCK. No, equity funds. Equity funds that are managed on a very, very conservative basis, attended by very conservative investments. There are other funds that have much higher betas, much higher volatility, and there are those people who love the idea of being more aggressive. Those would be funds that would be more heavily invested in technology, for example. People might think, "Gee, this is a great time for that kind of investment. Companies are going to go back into technology. I want to own technology funds."

About 20 percent of our investors describe themselves as "self-directed" investors. They come to our website every day. They scan all the 4,000 funds and they make their choices. Fifty percent of investors describe themselves as "validators." That is a term we use for people who do not want to turn over the management of their money to someone else, but they want to work with an adviser who helps them navigate all these choices while they maintain an active involvement. That takes time and energy.

Chairman SHELBY. At least they are watching you.

Mr. POTTRUCK. The 12b–1 fees are one of the ways for a fund like Ariel to help reimburse Schwab for the time and energy we spend explaining to investors about the Ariel funds so that they can make an informed investment choice.

Chairman SHELBY. Ms. Hobson.

Ms. HOBSON. I think that David answered it very well. The do-it-yourselfers are a small group, and then there is the validators and the designators, the people who want their decision confirmed and those who want someone else to make it for them. And the 12b–1 fees help us to pay those people who offer that advice and counsel.

As we have all noted, because this can be a very confusing area for American investors and because you do not learn about investing in school in America, we need a lot of help in making these decisions and discerning what is important, and I do believe that the payment for those services is also important. Ninety percent of our assets right now are coming from mutual funds supermarkets, Schwab and Fidelity, 90 percent for our company.

What is the benefit to the investor besides being able to talk to an informed person on the phone at Schwab, being able to get all of their investments on one statement at Schwab, having access to

a terrific website? Beyond that, as we grow, they get the benefits of the scale. One simple example of that, I looked back in 1998, the Ariel Fund, our flagship mutual fund had an expense ratio of 1.19 percent. Five years later, because the fund has grown because of the sources like Schwab and Fidelity, our expense ratio as of today is 1.02 percent. I am sorry. In 1998, it was 1.25 percent. It is 1.02 today, and so that is a 20 percent drop in 5 years. Because we have grown——

Chairman SHELBY. Because you have more to manage in economy of scale, is that it?

Ms. HOBSON. We have the economies of scale through Schwab and Fidelity.

Chairman SHELBY. Mr. Pottruck, you have testified that although the SEC's proposal for a "Hard 4 p.m. Close" would deter later trading, it will have unintended adverse consequences for some investors and will be particularly unfair to investors that invest through 401(k) plans which are important to all of us. We understand the need to halt late trading, but I also appreciate the concern about unintended consequences for investors. A number of the proposed alternatives to the "Hard 4 p.m. Close" rely on technological fixes. How feasible are these alternatives, and does the required technology exist or is that on the drawing board?

Mr. POTTRUCK. We and others are suggesting that, since 90 percent of mutual fund trades come through an intermediary on behalf of the fund, that intermediaries be able to apply to be a designated agent of the funds, and that when the intermediary takes the trade by 4 o'clock, that is considered to be an adherence to the "Hard 4 p.m. Close." We at Schwab take 50,000 mutual funds trades a day, and we have to aggregate all these trades before placing them. It takes us a little time to aggregate the trades and send the money and the information to the various funds so that they can manage their investing.

The technology to have hard-coded, unalterable time stamps as to when these trades came into the system exists, but it is not all implemented. It never occurred to us, frankly, that we had to make the field with a time stamp something that someone could not go in later on and override. Now, we have learned the importance of those kinds of protections. So those technologies need to be added, but they are not a technological challenge, it is just some time and money for us to put those in place.

Chairman SHELBY. Mr. Bogle, do you have a comment on that?

Mr. BOGLE. Yes. I think, first of all, the idea that you should make an investment decision based on what the market is going to do in the last 2 hours of the day if you are investing for a lifetime, strikes me as, for the want of a better word, nuts. Second, even a 4 p.m. close is not adequate for the proper conduct of this industry's affairs. It should be something like 2:30 so the money is known to be in there when the portfolio manager can invest it by the close of the day. In other words, the idea is to have the purchases the portfolio manager makes be made at the same price that reflects what the net asset value is, but that is a parity there, a linking, and at 4 o'clock it is too late to do that, so I would go for a 2:30 close. And as absurd as that might sound to you, that is actually the way we do our index funds, because there the pressure

to match is so heavy that you just have to close at 2:30 so the portfolio manager can buy that future at 4 p.m. and the fund is priced the same way.

But I think it is a good idea to have a hard close, and I am sure no one is going to agree with me. I do not think very many people are going to agree with me for a 2:30 close, it may be a tough medicine for everybody to swallow, but the abuses were worse, so we have just got to do something about it.

Chairman SHELBY. How much of the mutual fund money of Vanguard roughly is in index funds?

Mr. BOGLE. Order of magnitude, probably about $280 billion something like that, index stock and bond funds.

Chairman SHELBY. Ms. Hobson, do you have a comment on that?

Ms. HOBSON. I do not have anything to add to that.

Chairman SHELBY. Mr. Ruder, Chairman Ruder, we always addressed him as.

Mr. RUDER. Thank you, sir.

Chairman SHELBY. The SEC has not mandated a maximum number of fund boards on which independent directors can serve, at least not yet. What are the implications of directors serving on over 100 boards? We talked about that a little earlier. Further, what are the considerations for determining the appropriate number of boards on which a director serves, and who should make that determination?

Mr. RUDER. That is a very good question. When I first learned that directors were directors of 30, 40, 50, or 100 boards at the same time, I was astounded. Then I learned more about the industry. As Ms. Hobson said, there are similar aspects in funds which fund boards can examine at the same time, the governance functions, the compliance functions, and other functions. So it is quite appropriate to have a large number of funds with the same boards.

The boards can also look at the performance characteristics of the various funds. There must be a point, however, at which you want to say 100 is enough or 80 is enough or 250 is enough, and I think the SEC should look at the multiple board phenomonon very carefully. I cannot imagine Congress making that kind of decision, but someone should.

Chairman SHELBY. Ms. Hobson had some comments on that earlier, on the time I think Senator Sarbanes asked her a question about how much time they would spend on the board. You want to comment on this again?

Ms. HOBSON. No.

Chairman SHELBY. No.

Ms. HOBSON. I think I said enough on that one.

[Laughter.]

Chairman SHELBY. Mr. Bogle.

Mr. BOGLE. In any abstract sense it is absolutely absurd for a director to serve on 330 or 340 boards or even 100. I used to say a fiduciary duty test was whether they name each fund they were director of. Nobody could pass with 100 funds. I am absolutely confident of that.

Chairman SHELBY. I would hate to have the responsibility if something went wrong on one of those boards, the legal liability.

Mr. BOGLE. On the other hand, if I may add, sir, doing it the other way and having—if you have 330 funds, which I believe is a Fidelity number—having 33 boards would make Mr. Johnson, who is the king or the emperor now, it would make him into the Pope. I mean he would have no limits. His power would be absolutely unchecked if he had 10 different boards to deal with, all doing different things.

So my idea for balancing those interests is to require that no director could serve on more than, say, 10 fund boards unless the funds had an independent staff to assist the directors—an independent, objective staff on the fund's payroll to enable the directors to fulfill their fiduciary duty. I think that would be the best balance of interest.

Chairman SHELBY. Mr. Pottruck.

Mr. RUDER. Could I just comment once more on this?

Chairman SHELBY. Let me call on Mr. Pottruck first.

Mr. POTTRUCK. Thank you, Chairman Shelby. I think this is a very complicated issue. We have 40 or 45 mutual funds that are proprietary Schwab funds, where we have our own board that is in charge of these funds. The vast majority of what the boards look at relative to these funds is exactly the same, fund to fund to fund. There is an enormous economy of scale. Issues having to do with individual performances of individual funds are primarily dealt with on an exception basis. There is an expected benchmark for every fund. If the funds are within their benchmarks, there is not a lot of discussion that is necessary about their performance. So it is done on an exception basis.

But I would liken the issue of a board of funds where there are 100 or 150 funds, to the same question of whether boards of companies like Citigroup, one of the largest corporations in the world, can effectively oversee 500 operating subsidiaries? The main issue to me is how independent is the board? I would urge the Committee and the SEC to focus on the issue of independence by setting rules around, (a) what percentage of the board must be independent, and (b) what qualifies as independent? I think if you get strong independent board management, they will set their own agenda to do the right thing for the shareholders of the funds.

Chairman SHELBY. Mr. Ruder.

Mr. RUDER. If you have 100 boards in a complex, and you split those boards into 10 funds each so you have 10 boards, my guess is that the adviser would be much more powerful dealing with each of these 10 boards one at a time than if it had to deal with, say, two boards managing 50 funds. In the later case those boards would be able to assert their independence with regard to the adviser. This is a very competitive situation between the adviser and the funds, and you need to give those directors power.

Chairman SHELBY. Senator Sarbanes.

Senator SARBANES. I take it you all would agree with the propositions that the directors have a fiduciary duty? To whom do they owe the fiduciary duty?

Ms. HOBSON. Shareholders.

Mr. BOGLE. That is actually a wonderful question because of course they owe the fiduciary duty to the shareholders of the funds. But think about it a minute, Senator, the directors of the manage-

ment company that are on that board also owe a fiduciary duty to the shareholders of the management company. There can be no question about that. How do they serve those two fiduciary duties? How do they observe those two standards of loyalty to two completely different companies? I do not believe it can be done.

Chairman SHELBY. You have a bifurcated situation.

Mr. BOGLE. Well, no man can serve two masters. I read that somewhere.

Senator SARBANES. We had Glassman in here yesterday who was very close to arguing that they owed their fiduciary duty to the shareholders of the management company and not the shareholders of the mutual funds.

Mr. BOGLE. He had better not get into this industry.

Ms. HOBSON. If I could just add one thing to that point, at the end of the day when the system works—and I do not in any way suggest that we did not have some failures—all of those interests are in line because the management company knows very clearly that the only way that they can be successful is to have a successful and competitive fund that has good performance for the shareholders, that will attract and retain shareholders. So in situations where there is a sense that people are not thinking through—"people" meaning those of us who are on the management side and sitting on a board—how these funds affect our everyday business is not really realistic.

Senator SARBANES. That may be, but it seems to me that there is almost an inherent conflict of interest there because if you go one way, one side benefits, if you go the other way the other side benefits.

Ms. HOBSON. But not over any period of time because at the end of the day serving your shareholders well is the only way you are going to have a successful business in our industry. The investors vote with their feet. That is the one thing we have been able to see very clearly, be it their 401(k) plan, be it their IRA, their children's college account, or whatever it might be. When they become dissatisfied with that management company, with performance which has put them in more of a short-term performance derby, performance discussion, which I do agree with Mr. Bogle on, when they become dissatisfied, that leaves, and that hurts us as the management company.

Senator SARBANES. Would you say that there is a range in there where you as a very smart, knowledgeable investor might march with your feet, but most people would have to be pushed out to a point further along the spectrum before they would march with their feet?

Ms. HOBSON. That is not what the data is showing right now. I have read that the typical time that an investor invests in a mutual fund now has dropped to 3.5 years, and that is down from 7 years in the late 1990's.

Senator SARBANES. Do you think that is good or bad?

Ms. HOBSON. I think that is very bad. I am a company that has a turtle as a logo, so our motto is slow and steady wins the race. I think that is very bad. We call ourselves the patient investors.

Senator SARBANES. Then something is wrong with the way the rewards and punishments——

Ms. HOBSON. Because we used to pay so much to get those customers and worked so hard to get them, you have no incentive to have them leave.

Senator SARBANES. You do not want to lose them, do you?

Ms. HOBSON. Right. The customer you have is the one that you want most of all.

Senator SARBANES. Yesterday, we had testimony on the standard for the fiduciary duty, referencing the Gartenberg decision in the Second Circuit, which established a very loose, in my view, standard of fiduciary duty. In fact, the court said to be found excessive, the trustee's fee must be so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining. This, since then, has been insurmountable. No shareholder has subsequently proved a violation of the Gartenberg standard that was initially found with regard to the fiduciary duty of the adviser, but the courts have now extended it to the standard for directors as well. So there is some thinking that we need to address this question of what the standard of duty is, of fiduciary duty that the directors have. Would you all agree with that?

Mr. BOGLE. I would like to say, if I may, Senator Sarbanes, that I actually have been doing a little work on that and spoke about it this morning in a different venue, and that is the Gartenberg standards and almost all the standards we see have a terrible flaw, and that is they look at basis points, the number of percentage points that you charge, and you compare one fund charging 60 basis points and one fund charging 40. They say, well, 20 basis points doesn't seem to be that big of a difference, so there is no problem there.

I think what we have to do—and I will just give you a couple of numbers—is talk about dollars and dollars as a waste of corporate assets. It will open the eyes of the world. I have looked at the California PERS, the California Public Employees Retirement System, and found that mutual fund shareholders typically pay their fund managers 100 to 150 times as much as CalPERS pays for the same manager providing the same service. The mutual funds' fees in basis points are only like 5 times higher, but in terms of dollars, the fees paid to the mutual funds are 100 to 150 times higher than what the manager charges an outside party with only a fraction of the assets. I believe that to be a complete waste of corporate assets.

I will give you two specific examples in the mutual fund field. There is a large money market fund which has done us a wonderful favor by separating their fee for distribution and their fee for administration and their fee for investment management. You put all of that together and you can therefore pull out how much is actually paid for investment management. That money market fund, just 2 years ago, paid $257 million for the money managers who pick A–1, P–1, and Treasury CDs. That is all there is to it, A–1 paper and P–1 paper, CDs and Treasury bills, $257 million. If the cost of those three or four people at the desk is a million dollars, I would eat my hat, which I am not wearing today.

Another example. There is a very large mutual fund that once had a very good record. It got so large that it could never duplicate that record again, and in the last 10 years it failed to do so. It be-

came essentially an index fund. It correlates with the index at about .97 or .98. But its huge size was great for its management in that decade, and despite its loss to the stock market, the management was paid $3.6 billion for investment management, $3.6 billion for managing what is, in fact, an index fund. Sure, they are going to tell you the rate is only 80 basis points, but $3.6 billion, sir, is $3.6 billion, and it is not right.

Ms. HOBSON. I think the issue about the difference between the institutional accounts and the mutual fund accounts is a very important issue. I address that in my testimony and in my written testimony as well. I think that there are some things that are getting lost there that are very important. We manage institutional accounts and we manage mutual funds, and I mentioned we had $5.5 billion in mutual funds, but we have lots of large institutional accounts around the country. There is a fundamental difference in what we do in those two businesses.

In both situations we are the investment manager, and we are providing our investment strategy in a very clear and disciplined way. However, on the mutual fund side of our business we have to have licensed professionals talking on the phone to the shareholders. When working for CalSTRS, which we do, we do not have millions of California employees calling directly to Ariel about their institutional account that we manage for them that is several hundred million dollars. It just does not happen. We have to have a 24-hour website that gives the individuals access to their account, up-to-date information performance. Millions of institutional employees pension fund people do not call our firm and ask us for that same opportunity. We have to have legal accounting compliance. A lot of times the legal in the institutional accounts is done by the plan sponsor. Last but not least, we have to put together shareholder letters and special brochures and things like that to keep the customers informed. I never communicate directly with the pensioneer with Ford Motor Company, which is one of our clients.

So there is a fundamental difference in those businesses. Investment management is just one piece of the business as it relates to the mutual fund side.

Chairman SHELBY. Chairman Ruder.

Mr. RUDER. I have spent my life worrying about corporate governance in one way or the other, and I find it very hard to deal with the problem of what some would call excessive fees in this industry. I do not think that the Government should be addressing the fee question directly to say fees are too high or they should be capped. Nor do I think the problem should be addressed by setting fiduciary standards to say there is some level at which we are going to penalize the directors or the managers of these funds because they have not met the standard we have set. I do not see the fiduciary duty approach as a way to get to this problem, because it is an indirect way of setting fees in an industry which is highly complex, very difficult, and as Ms. Hobson has told us, in which it is very hard to know what the right answer is.

I can only say that I think compliance and transparency, both to the investors and to the boards, and good management are going to give us the results that we need.

Senator SARBANES. Don Phillips, Managing Director of Morningstar, testified before us yesterday, and he said:

At Morningstar we think it is time to eliminate soft-dollar payments and to eliminate or seriously reconsider the role of 12b–1 fees in funds. Investors deserve a clear account of how their money is being spent. Allowing fund managers to dip into shareholder assets to promote asset growth or to offset research costs distorts the picture, makes it difficult for investors to align costs and benefits. Let us keep thing clean and clear. Costs whose benefits flow primarily to the fund's adviser should be on the adviser's tab, not passed off as investor expense. Moreover, distribution costs should be paid directly to distributors, not run through the fund's expense ratio where they tempt managers to take risks they otherwise would avoid. Pricing schemes should not compromise the integrity of the investment management process.

What is your take on that?

Mr. RUDER. Sir, if you look at my prepared statement, I have agreed with all of those positions. I think the adviser should pay distribution costs and management costs out of its own budget, and those costs should be very transparent to the board. We should eliminate soft dollars and directed brokerage for the use of the advisers, and as I have said, eliminate the protection of Section 28(e). Those are all wonderful suggestions.

Senator SARBANES. Mr. Pottruck.

Mr. POTTRUCK. There are a lot of different things that different mutual fund companies do on behalf of their clients. The key, to my way of thinking, is that there is effective disclosure and that on at least an annual if not quarterly basis, mutual funds must disclose in great detail where money goes and what money pays for in these different fund complexes.

We are in the business of institutional brokerage so some of our research is paid for with soft dollars. However, having said that, I think a study of that practice is very much in order. I think that mutual fund advisers should be able to buy research and charge that to the fund as a separate line item and a separate expense. It is on behalf of the funds. It helps the fund shareholders when they have more research information. Paying for it with the brokerage commissions is probably the least good way of doing that. It should be broken out and be more specific so we can see if it seems to be excessive. It gives investors more information.

Effective disclosure will be the simplest tool to help investors, rather than lots of rules and regulations on exactly how much is a reasonable level of fees for different kinds of things. The intensity of competition in this industry should not be underestimated. I think many people underestimate how intense the competition is. We worry about the problems of investors who move on, the turnover. Indeed, the time duration of people holding onto a mutual fund has come down. All of that argues for the intense competition in our industry. If you do not perform for the client, people vote with their feet. They vote with their wallets every day.

Ms. HOBSON. The only thing I would add to the discussion is—and Don Phillips' quote I think is appropriate, that pricing schemes should not compromise the integrity of the investment management process. No investment manager wants their performance compromised by high fees, I can tell you that, because typically they are very competitive people who want to win and show up as being one of the high performers or the best performers.

But I do think one thing that is missing there is that the investment manager, in many cases, firms like Ariel, we are paying for part of the distribution out of our pocket. Our 12b–1 fee on our funds is 0.25 percent. However, Schwab and Fidelity charge us 40 basis points, 0.40 percent. So in those situations, in order to get the access to distribution that we think is very valuable and valid, we have to pay out of our pocket the difference.

So this idea that it is totally being passed on to the shareholder just based upon the way the costs work is not necessarily the case. In some of the 401(k) situations that we are in, if we are in a 401(k) plan where the provider is a Merrill Lynch or a Vanguard or others, in order to have another fund come in, the provider, the company that has the whole kit and caboodle to the plan, the administration, enrolling the employees, providing the investment management options, in those situations sometimes they will make the barrier for us to come in as high as 50 basis points just to be on the list alongside of the other mutual funds. So, we would say, okay, we have to pay for that right, but if that means—which did happen for us last year—we can now be on the Wal-Mart 401(k) plan list, which we are, and 1.4 million employees now have access to Ariel through their relationship with Merrill Lynch that they have at Wal-Mart. We think that that is not only good for us, as people are working hard to grow our business, but it is also good for the shareholders as the assets go up and the expenses on the funds go down, as we have been able to demonstrate.

Senator SARBANES. Mr. Bogle.

Mr. BOGLE. Nothing makes it more clear that we are in a marketing business, an asset gathering business, than when we hear phrases like "point of sale" and "shelf space" and all of that, and that is fine as far as it goes. Every industry needs some of that. But all those costs, which are staggering, are a dead weight on the returns that are earned by mutual fund shareholders. There is no way around it. And research does not bail you out. It is not at all clear that research has any value at all. How could it have any value when everybody is sharing it together and the stock you buy with Merrill Lynch's research is the stock someone else sold because of Merrill Lynch's research? If there was ever a zero-sum game, that is it, except for Merrill Lynch, who does very well because people buy this research with their shareholders' money, and, of course, everything is very cheap when you are buying it with other people's money.

It is all part of this idea that we just cannot simply get through our heads that mutual funds lose to the market by the amount of their cost year after year, and those costs are something like $125 billion. There is no way around that equation because we cannot all be smarter than all the rest of us. We really should be thinking much more about simplifying the business and taking some—I would not argue all—of the marketing costs out of the business, and certainly getting rid of soft dollars is something that is going to have to happen. It is going to be a very difficult adjustment for this industry and for Wall Street, but it is going to happen. I mean if you want to get on the right side of history, do away with it gradually. And 12b–1 the same thing. It can be held together with bailing wire and thumbtacks for a while but not forever. We know

where it is all going to come out because the investor finally will be served.

The problem with this is that time is money, and huge money when you talk about compounding, and the longer we let these ills go on the more we disserve the American investor, in my judgment.

Ms. HOBSON. I think it is easy to have that perspective when you have $750 billion in assets and terms like "marketing" and "shelf space." You just feel differently about them when you are like the 370 mutual fund companies that are like Ariel that have $5 billion or less in assets. It is just a different discussion.

Chairman SHELBY. We appreciate all of you here today. It has been a lively discussion, distinguished panel. We have a vote on the floor of the Senate. Thank you for the contributions you have made today. We will continue these hearings to see what we need to do from a legislative standpoint. Thank you.

The hearing is adjourned.

[Whereupon, at 4:12 p.m., the hearing was adjourned.]

[Prepared statements and additional material supplied for the record follow:]

PREPARED STATEMENT OF DAVID S. RUDER

FORMER CHAIRMAN, U.S. SECURITIES AND EXCHANGE COMMISSION
WILLIAM W. GURLEY MEMORIAL PROFESSOR OF LAW
NORTHWESTERN UNIVERSITY SCHOOL OF LAW
CHAIRMAN, MUTUAL FUND DIRECTORS FORUM

FEBRUARY 26, 2004

Introduction and Background

Thank you for asking me to testify on the important question of mutual fund reform. My views are my own and not those of any group or entity. I am currently a Professor of Law at Northwestern University School of Law, where I teach securities law. I was Chairman of the U.S. Securities and Exchange Commission from 1987 to 1989 and was a member of the Board of Governors of the National Association of Securities Dealers, Inc. from 1990 to 1993. While a member of the NASD Board, I was chairman of a committee that reviewed securities industry practices in and promulgated a report on the topic "Inducements for Order Flow," [1] sometimes known as "payment for order flow."

Currently, I serve as Chairman of the Mutual Fund Directors Forum, a not-for-profit corporation, whose mission is to improve fund governance by promoting the development of vigilant and well-informed directors. We do so by offering continuing education programs to independent directors, providing opportunities for independent directors to discuss matters of common interest, and serving as advocates on behalf of independent directors.

The Forum is a membership corporation whose members are all independent directors of mutual funds. Their dues are paid by their funds, but their memberships are individual. The Forum is entirely independent of the mutual fund advisory industry.

In November 2003, the Securities and Exchange Commission Chairman William H. Donaldson asked the Forum to develop guidance and best practices in five areas where directors oversight and decisions are critical for the protection of fund shareholders. In our view, Chairman Donaldson's choice of the Forum to develop guidance and best practices in critical mutual fund areas demonstrates the SEC's confidence in the Forum's capability and independence.

Finally, by way of background, I am currently serving as the Independent Compliance Consultant for the Strong Financial Corporation, which manages approximately $37 billion in assets and is the adviser to more than 50 mutual funds. My task is to recommend compliance procedures at Strong, including the areas of market timing, late trading, portfolio valuation, and disclosure of portfolio holdings.

The Role of the Mutual Fund

A mutual fund provides a vehicle through which the pooled resources of investors can be managed by professional money managers (investment advisers or advisers). Though mutual funds' investors are able to achieve the benefits of diversification and to seek above average returns by investing in funds with special characteristics, such as growth funds, income funds, or sector funds.

In addition to offering diversification and special investment vehicles, mutual funds provide other advantages to investors. Individual investors are unlikely to be able to gather the information necessary to make good investment decisions, and they do not have the experience or judgment enabling them to outperform professional managers. Mutual funds provide them with the opportunity to compete with the professionals.

Equally important, the discipline of regular investing in mutual funds, with an expectation of long-term investment profit, creates saving habits that are beneficial to investors.

Directors as Monitors

When a mutual fund investor entrusts funds to an investment adviser, conflicts inevitably arise. The adviser seeks to maximize their profits, while the fund shareholders want the adviser to charge the lowest fees possible. Conflicts also exist because the adviser who has control over investors' money may engage in transactions with the fund that are to the advantage of the adviser and to the detriment of investors.

[1] National Association of Securities Dealers, Inc. (1994).

The Investment Company Act of 1940, as administered by the SEC, recognizes these conflicts by laws and rules designed to prevent conflicts of interest and by placing special governance responsibilities on mutual fund boards of directors.

The most important approach to increasing the protection of mutual fund investors is to enhance the power of independent fund directors and to motivate those directors to perform their duties responsibly.

The Unique Form of Mutual Fund Organization

As presently constituted, the mutual fund industry has a unique form of organization. In an industrial corporation, the primary function of the board of directors is to supervise the management of the corporation. The board has the ability to hire and fire the corporate chief executive officer, as well as other officers, and has the power to set corporate policy. The board has the power to tell the corporate officers how to manage the business.

In contrast, in the typical mutual fund, the board of directors is not dealing with a CEO or other officers charged with management of the corporation, but with an entity—a mutual fund adviser whose obligations to the fund are determined by contract. Typically the fund board does not have a separate office or a staff. The CEO of the fund will be an employee of the adviser, and the CEO's allegiance typically will lie primarily with the adviser.

Given the separation between the fund board and the adviser, the important question to be asked is: What organization and powers will best assist a fund board in protecting the interests of the fund and its shareholders?

I will examine this question, and will also examine some specific current areas of concern in the mutual fund area.

In deciding what corporate governance structure is desirable, the Congress and the SEC need to understand that for the most part fund directors are well-informed, dedicated, and active in their supervision of the adviser. Any reform in the mutual fund governance area should be aimed toward improving the powers of fund directors to perform their supervisory functions.

To say that most fund directors are well-informed, dedicated, and active does not mean that all fund directors share these qualities. Historically mutual funds have been created by investment advisers that are extremely knowledgeable about the securities industry and the intricacies of mutual fund management. In many cases, the independent fund directors have been chosen by the adviser. Some fund directors charged with supervising the adviser may at times be unwilling to challenge an adviser who has the advantage of superior knowledge and resources. The SEC has stated:

> Our concern is that in many fund groups the fund adviser exerts a dominant influence over the board. Because of its monopoly over information about the fund and its frequent ability to control the board's agenda, the adviser is in a position to attempt to impede the directors from exercising their oversight rule. In some cases, boards may have simply abdicated their responsibilities, or failed to ask the tough questions of advisers; in other cases, boards may have lacked the information or organizational structure necessary to play their proper role.[2]

There are some directors who are not meeting high standards as supervisors of fund activities, because they are new to a complex industry, because they have not taken the time to become fully informed, or because they are friendly to the adviser. Some directors do not meet supervisory standards because they are not sufficiently assertive in carrying out their duties.

Our primary tasks at the Mutual Fund Directors Forum are to assist independent directors to become better educated and to be more active in overseeing management of their funds by advisers.

In assessing director performance, it is important to recognize that the mutual fund industry is complex. Mutual fund boards are ultimately responsible for supervising many fund functions, including:

- Advisory fees and fees of other entities providing services;
- Compliance with representations made in documents distributed to prospective investors and fund shareholders;
- Performance of the fund portfolio;
- Quality and cost of portfolio executions;
- The manner and cost of the distribution of fund shares;
- The custody of the fund's securities; and
- Administration of individual investor accounts.

[2] Proposed Rule: Investment Company Governance, Rel. IC–26323 (January 15, 2003) p. 3.

These functions will be carried out by the adviser and by other entities, sometimes collectively called "service providers." The term "service providers" includes not only advisers and sub-advisers who manage fund portfolios, but also underwriters who sell fund shares, administrators of customer accounts, and transfer agents who record transfers of shares in customer accounts. Custodians who hold fund portfolio securities both in the United States and abroad, fund accountants, and third-party pricing services may also be considered to be "service providers." [3]

In order to monitor the adviser, the fund directors need to understand the fund's operations, have the power to assure that the fund operations are being carried out honestly and efficiently, and have the will to exercise these powers for the protections of shareholders. They must bargain with the adviser regarding the costs of its services and regarding the cost of arrangements made by the adviser to have others perform services.

An Overview of Needed Regulation

Recent events have revealed that there are serious problems in the mutual fund industry. Advisers have facilitated late trading, market timing, and improper disclosure of mutual fund portfolio holdings. Advisers have used fund portfolio execution revenues and their own resources to pay brokers to advocate purchase of funds managed by the adviser, without adequate disclosure to investors.

The recent problems are being addressed by both State regulatory authorities and the Securities and Exchange Commission. The SEC has been charged by Congress with regulating the complicated investment company industry since 1940, and it has performed that regulation well, given its limited resources. Nonetheless, some of the recent scandals have caught the Commission by surprise. In reaction, the Commission has recently been vigorous in its enforcement activities, has imposed numerous reforms through new rules governing the activities of funds and advisers, and is preparing additional rules.[4]

As noted earlier, the mutual fund industry is highly complex. Detailed regulation is best left to the discretion of the agency that has expertise regarding the mutual fund industry and can regulate in a manner that will reflect changing industry patterns and technology in both the mutual fund industry and in the securities industry generally. *I believe Congress should be very cautious in addressing mutual fund reform by legislation. I urge Congress to recognize that for the most part needed regulatory steps are being taken by the SEC through its rulemaking and enforcement powers under the Investment Company Act, the Investment Advisers Act, the Securities Act, and the Securities and Exchange Act.*

Corporate Governance Reforms

The Mutual Fund Directors Forum recently conducted a policy conference on the Critical Issues for Mutual Fund Directors. At that conference it was my pleasure to listen to numerous independent directors express their desire to increase their oversight of the advisers. My recommendations for reform are designed to increase the oversight powers of fund directors and to help independent directors be more assertive when they deal with fund advisers.

INDEPENDENCE

The first criteria for exercise of independent oversight is that a sufficient number of directors be independent of the adviser.

1. *At least three-fourths of each fund board of directors should be independent of the adviser.* The SEC has proposed this requirement.[5]

2. *Director independence standards should be tightened by the SEC.* The Investment Company Act's definition of "interested person" does not sufficiently address problems of indirect relationships, such as former employment with the adviser, family relationships, and other matters.

AN INDEPENDENT CHAIRMAN OF THE FUND BOARD

The chairman of the board of each fund should be independent of the adviser. An independent chairman can control the board agenda, can control the conduct of board meetings so that important discussions are not truncated, and can provide im-

[3] See Note 28 in SEC Releases IA–2204 and IC–26299 (December 17, 2003).

[4] See, e.g., SEC Proposed Rule: Confirmation Requirements and Point of Sale Disclosure Requirements for Transactions in Certain Mutual Funds and Other Securities, and Other Confirmation Requirement Amendments, and Amendments to the Registration Form for Mutual Funds. Releases 33–8358; 34–49148; IC–26341 (January 29, 2004).

[5] Proposed Rule: Investment Company Governance, Rel. IC–26323 (January 15, 2003).

portant and direct liaison with the adviser between board meetings. The SEC has proposed this requirement.[6]

AN INDEPENDENT COMMITTEE STRUCTURE

At the urging of the SEC, the New York Stock Exchange and the Nasdaq Stock Market now require that the Board Nominating, Compensation, and Audit Committees be composed entirely of independent directors. Similar committees and other committees composed entirely of independent directors are important to assuring good fund governance. The SEC should urge or perhaps mandate that various committees exist, taking into account that funds are different in size and objectives. Some fund boards, particularly in smaller funds, may choose to deal with some matters solely at the board level.

I recommend that fund boards in the larger complexes function with the following committees.

A Nominating Committee

A Nominating Committee composed entirely of independent directors should have exclusive power to nominate directors, thereby helping to assure that new independent directors of each fund will not be chosen by the adviser.

An Audit Committee

An Audit Committee composed entirely of independent directors should have responsibility to oversee the audit function and the power to hire, terminate, and set the compensation of the auditor.

A Compliance Committee

A fund board may wish to create a Compliance Committee composed entirely of independent directors. The Committee should have the primary responsibility for overseeing the compliance policies and procedures of advisers and service providers, and should be responsible for overseeing the content of their ethics codes. The Committee should monitor the fund's compliance functions, including the activities of the chief compliance officer.

An Investment Committee

Although practices in each fund complex may differ, some funds may choose to create an Investment Committee composed entirely of independent directors, charged with the review of investment performance and fund fees and costs.

Other Committees

Other committees, such as a valuation committee, should be established as deemed desirable by the fund board.

INDEPENDENT COUNSEL AND STAFF

Since most mutual funds are "externally" managed by the adviser, it is important that the board of directors have independent counsel and staff.

Independent Counsel

In 2001, the SEC required any legal counsel to the independent directors of funds relying on certain exemptions to be independent from the adviser.[7] As a result, many independent fund directors now have legal counsel who can provide independent advice to the fund board regarding board governance matters and the entire range of fund operations. A fund board should be sure that its counsel is, in fact, independent and is acting independently. *The SEC should require that the independent directors have an independent legal counsel.* In the absence of SEC action, all independent directors should strongly consider retaining their own independent counsel.

Independent Staff

The Sarbanes-Oxley Act mandated that the Audit Committee of each company registered with the SEC have the power to hire independent staff. The stock exchanges have recommended that the nomination and compensation committees be empowered to hire independent staffs. *Mutual fund boards should be able to hire an independent staff on a permanent basis or on an as needed basis. They should be able to hire independent advisers to advise the board in areas such as fund fees and costs, the quality of portfolio executions, and the valuation of fund securities.*

[6] *Id.*

[7] Role of Independent Directors of Investment Companies, Rel. IC–24816 (January 2, 2001).

A CHIEF COMPLIANCE OFFICER

Each investment adviser should be required to hire a chief compliance officer (CCO), charged with supervising the compliance functions of the adviser and its service providers. The CCO should report to the fund board, as well as to the adviser. The fund boards should have the right to hire, fire, and set the compensation for the chief compliance officer. Mutual fund advisers typically provide investment advice not only to mutual funds, but also to other clients, such as high net worth individuals, 401(k) retirement plan advisers, and institutions such as pension plan sponsors. The adviser's chief compliance officer should report to the fund board regarding adviser compliance in all aspects of the adviser's operations that are likely to impact the fund's operations, including the adviser's supervision of sub-advisers and service providers. The chief compliance officer should be well paid, have high ranking officer status within the adviser, and have his or her own staff.

My recommendations are not new. The SEC has adopted rules requiring chief compliance officers at both advisers and funds.[8] Rules under the Investment Advisers Act will require each adviser to have a chief compliance officer, meeting the criteria I have set forth. Similar rules under the Investment Company Act will require mutual funds to have a chief compliance officer. The SEC's new Investment Company Act rule adds important additional levels of detail:

- The chief compliance officer must annually provide a written report to the fund board regarding operation of the fund's policies and procedures, as well as those of the fund's service providers.
- The chief compliance officer must meet with the fund board in executive session as least once each year.
- The chief compliance officer must oversee the fund's service providers, including their compliance officers, and should keep the fund board aware of compliance matters and needed changes at the service providers.[9]

POLICIES AND PROCEDURES

Advisers and funds should adopt and implement written compliance policies and procedures. The SEC's recently adopted Investment Advisers Act rule[10] will require the adviser to adopt and implement written policies and procedures reasonably designed to prevent violation of the Advisers Act by the adviser. The rule specifies a number of areas that should be addressed, including portfolio management, trading practices, proprietary trading, the accuracy of disclosures, the safeguarding of client assets, and portfolio valuation procedures.

The SEC has also adopted a similar rule under the Investment Company Act[11] requiring fund boards to adopt written policies and procedures reasonably designed to prevent the funds from violating the Federal securities laws. As with the adviser rule, the Investment Company Act rule also specifies a number of areas that must be addressed. In the corporate governance area, the SEC's investment company rules require funds to have policies and procedures designed to oversee compliance by the adviser and the service providers, including principal underwriters, administrators of shareholder accounts and transfer agents. The rule specifies areas that should be addressed, including the areas identified for fund advisers, as well as pricing of portfolio securities and fund shares, processing of fund shares, and compliance with fund governance requirements. The latter requirements include board approval of the fund's advisory contracts, underwriting agreements, and distribution plans.

CERTIFICATION

The Sarbanes-Oxley Act and SEC rules now require chief executive officers and chief financial officers of industrial corporations to certify in disclosure documents that the issuer's financial statement fairly present the company's financial condition and that the company's internal controls and procedures are effective.

Some have suggested that fund directors or the fund board chairman be required to certify to shareholders regarding oversight activities. I do not believe that such a certification requirement is needed or advisable. Such a requirement is not needed because fund board's are increasingly becoming more active in supervising advisers and service providers and will be even more active under new SEC rules. A certifi-

[8] Investment Advisers Act Rule 206(4)–7 and Investment Company Act Rule 38a–1. Final Rule: Compliance Programs of Investment Companies and Investment Advisers, Rel. IA–2204; Rel. IC–26299 (December 17, 2003).

[9] Rule 38a–1, *Id.*

[10] Investment Advisers Act Rule 206(4)–7, *Id.*

[11] Investment Company Act Rule 270.38a–1, *Id.*

cation requirement for fund directors is not advisable because it would deter qualified individuals from serving as directors.

A MUTUAL FUND OVERSIGHT BOARD

Some have suggested a mutual fund oversight board be established for the purpose of overseeing the mutual fund industry in a manner similar to the oversight regarding the activities of accountants now being performed by the Public Company Accounting Oversight Board. *I do not believe such a mutual fund oversight board is necessary. The SEC has full authority to exercise such oversight, is increasing its oversight and rulemaking activities, and has recently been given additional resources that will help it to perform its oversight functions.*

Areas Needing Attention

In evaluating possible legislation Congress should be aware of the complexity of the issues faced by mutual fund directors in monitoring the activities of advisers and the funds service providers. I will address several areas of particular current concern.

ADVISORY FEES

As noted earlier, a fundamental conflict exists between the mutual fund directors, who should be seeking the lowest fees from advisers consistent with good performance and the adviser, who will be seeking the highest profits for its services.

In reviewing advisory fees, the fund board should consider portfolio performance, the quality of the adviser oversight of service providers, the levels of volume breakpoints that provide reduced fees to the funds based upon fund size, compensation received by the adviser through its affiliates or from directing portfolio brokerage, and other factors.

Criticisms of mutual fund fee levels have been made by a number of well-informed persons. These critics contend that mutual fund boards have too readily acceded to management's recommendations. They also challenge fee levels in index funds and some debt funds that do not require judgments regarding the likely future value of particular securities.

Accepting the proposition that fund directors can be more active in attempting to reduce advisory fees, I believe the proper way to achieve better control over advisory fees is to improve the corporate governance environment for independent directors, to increase director education as we are attempting to do through the Mutual Fund Directors Forum, to encourage directors to be more assertive and energetic in challenging adviser recommendations, and to mandate increased disclosure regarding the fee setting process.[12]

I strongly believe that neither the U.S. Government nor State governments should attempt to set mutual fund advisory fees. Government price setting is inadvisable and wrong in the exceedingly complex and competitive mutual fund industry.

BEST EXECUTION AND DIRECTED BROKERAGE

One difficult task for a fund board is to assure that the fund is receiving best execution in fund portfolio transactions. All fund boards are concerned with execution practices and will normally insist that the adviser demonstrate that it is achieving best execution in portfolio transactions. The adviser will present details and comparisons regarding best execution to fund boards on a regular basis. Statistical analysis by third-party consultants is sometimes provided.

Although best execution is a goal, the definition of best execution is highly subjective. The definition is frequently said to mean the achievement of the most favorable price under the circumstances, including commissions, market conditions, and the desire for prompt execution.

Mutual fund portfolio transactions almost always involve transactions in large numbers of shares. In highly liquid markets, some large transactions can be accomplished without causing market price movements. However, mutual fund transactions are frequently so large in size that the execution must be accomplished confidentially and carefully so that the transaction does not unduly affect price. Some of the more difficult transactions are conducted by brokers who are highly skilled at executing large size transactions without revealing the size of the order or by electronic communications networks that have the ability to use computers to execute orders in stages without revealing size.

Substantial competition exists among executing brokers for the right to execute transactions. These brokers will be compensated based primarily upon a per share

[12] See SEC Proposed Rule: Disclosure Regarding Approval of Investment Advisory Contracts by Directors of Investment Companies. Rel. IC–26350 (February 11, 2004).

commission charge, which now is said to vary between approximately 3 and 6 cents per share for large transactions.

The competitive environment for portfolio execution commissions has caused many executing brokers to offer cash payments or equivalent payments in kind for the execution privilege. These payments are sometimes called "directed brokerage" payments and are sometimes used to pay for the costs of adviser research, to pay distribution costs incurred by advisers for fund shares, and to pay service providers for costs owed to entities providing services for funds.

I believe that directed brokerage is the property of the funds, who should receive the benefit of these payments. I believe payment to service providers on behalf of the funds meets this objective, but that payments that benefit advisers, such as soft-dollar payments and payment for distribution costs do not, unless these payments are quantified and utilized by fund boards to reduce advisory fees. *I believe the SEC should adopt a rule requiring all directed brokerage to be used for the benefit of funds, not the benefit of fund advisers.*

SOFT DOLLARS

Directed brokerage payments used to pay research or brokerage costs of fund advisers are called "soft dollars." Section 28(e) of the Securities and Exchange Act protects the adviser against liability or administrative action for payment of an excess amount of commissions for effecting a securities transaction if the adviser "determined in good faith that such amount of commission was reasonable in relation to the value of the brokerage or research services received" by the adviser.[13]

The value of research services received for soft dollars is often difficult to measure, so that soft-dollar payments often lack transparency. Additionally, as soft-dollar practices have developed, the SEC has by release expanded the allowable use of soft dollars to pay for services that seem to me to be far removed from research or brokerage.[14] For instance, services sometimes include costs of computers. Provision of these and other services often creates recordkeeping problems because of the need to separate services applicable to research and brokerage from services that are not applicable to these functions. It is also important to monitor soft-dollar payments to see that the funds generating commission dollars are receiving appropriate credit. Even if allocated properly, the amount of soft-dollar payments made to the adviser should be revealed to and approved by the fund directors.

I believe that protection given to soft-dollar payments by Section 28(e) is wrong and creates unnecessary complications. Congress should repeal Section 28(e), and the SEC should deal with soft-dollar payments by rule.

USE OF DIRECTED BROKERAGE FOR DISTRIBUTION

Recently the SEC brought and settled administrative proceedings with Morgan Stanley DW, Inc.[15] based upon alleged violations of SEC rules by Morgan Stanley when it accepted payments from mutual fund advisers in return for rewarding its sales personnel for selling shares of funds sponsored by those advisers rather than the shares of funds sponsored by nonpaying advisers. The advisers' motive in paying Morgan Stanley was to increase the amount of assets under management and therefore their advisory fees. The Commission asserted that by accepting these payments for "shelf space" without disclosing them to investors Morgan Stanley violated SEC antifraud rules prohibiting misrepresentations to investors.

The Commission's action also noted that a portion of the payments to Morgan Stanley amounted to the use of directed brokerage by the investment advisers to pay for distribution costs. This practice of using revenues from fund brokerage to pay third parties for the benefit of the adviser is similar to the advisers' receipt of soft dollars from directed brokerage. Unless the use of directed brokerage by the adviser to pay for the distribution of fund shares is revealed to and approved by fund directors, this practice is unacceptable. Adviser acceptance of directed brokerage to pay for its distribution costs is not protected by Section 28(e).

I believe the Commission should adopt a rule requiring the adviser to use all directed brokerage revenues for the benefit of the funds. It may be that if the adviser chooses to forgo all directed brokerage revenue, best execution of fund shares will be improved.

[13] Securities and Exchange Act, Section 28(e).
[14] SEC Rel. 34–23170 (April 23, 1986).
[15] *In the Matter of Morgan Stanley DW, Inc.* Securities and Exchange Act Rel. 48789 (November 17, 2003).

RULE 12b–1

In 1980, the Commission promulgated Investment Company Act Rule 12b–1[16] which permits mutual fund assets to be used to pay for the distribution of fund shares. The theory underlying the rule is that the use of fund assets to pay for distribution is justified because as assets increase, advisory fees as a percentage of assets will decrease. The assertion is that when certain levels, called break points, are reached, advisory fee levels will decrease.

Rule 12b–1 requires fund board approval for the use of fund assets to pay for fund distribution costs. Some have suggested that at the very least the use of directed brokerage revenues to pay for fund distribution costs should be included as a 12b–1 fee, which must be approved by the fund directors. My view is that the advisers should pay all of the costs of fund distribution and, therefore, Rule 12b–1 should be repealed by the SEC. If that rule is not repealed, use of directed brokerage to pay for fund distribution costs should be included as part of 12b–1 fees, subject to approval by the fund directors.

With regard to inclusion of directed brokerage in 12b–1 fees, as with other aspects of directed brokerage revenues, I believe Congress should refrain from legislation, and await SEC action.

LATE TRADING AND MARKET TIMING

New York Attorney General Spitzer's investigation involving the Canary Hedge Fund and subsequent SEC inquires and actions have raised important concerns in the areas of late trading and market timing.

Late Trading

Late trading is the practice by which a fund allows orders to buy or sell fund shares to be placed after the time at which the fund determines its net asset value (NAV), which in turn determines the per share net asset value used to price purchases and sales of fund shares. Late trading allows an investor to buy or sell shares at prices that will differ from the next day's prices to the advantage of the investor. The investor may profit if it is in possession of information that will cause the NAV to change on the following day. The practice of late trading is unlawful under SEC Investment Company Act Rule 22c–1, which prohibits an investment company from selling or redeeming fund securities except at a price based on the current net asset value of the security next computed after the order is placed. Late trading has the effect of allowing securities to be valued at a NAV computed before the order is placed.

Late trading activities have been aided by fund transfer agent practices allowing submission of orders by third-party fund distributors after the NAV pricing time. The distributors are usually brokerage firms that receive customer fund orders during the day and submit so called omnibus orders aggregating smaller customer orders into large buy and sell orders. Industry practice has been to allow these orders to be submitted as late as 7 p.m. or 9 p.m. Eastern time, or even later. Use of these omnibus accounts raises the possibility that the orders were actually received after the NAV pricing time in violation of the late trading prohibitions.

The SEC has attempted to meet the late submission problem by proposing a "hard close" of 4 p.m. Eastern time, requiring that all purchase and redemption orders be received by the fund no later than the time the fund prices it securities.[17] *Since late trading is already illegal and since the SEC is addressing late trading practices, no legislation is needed.*

Market Timing

Market timing is the practice of engaging in short-term trading of fund shares in order to take advantage of situations in which the fund's net asset values will not reflect the real value of the fund's shares. This practice allows the market timers to take advantage of information learned prior to the time at which the fund values its assets at the end of the day, but which will not be reflected in the NAV. The most frequently used illustration of this practice involves the pricing of foreign securities when foreign markets have closed many hours before NAV pricing. If events occur during the intervening period that will be likely to cause changes in the prices of the foreign securities, the market timer can buy or sell the fund shares on the day the events occur, taking advantage of the fact that the fund shares will not reflect the changed values of the foreign securities. Market timing is not illegal, but

[16] SEC Inv. Co. Act Rel. 16431 (1980).

[17] Proposed Rule: Amendments to Rules Governing Pricing of Mutual Fund Shares. Release IC–26288 (December 11, 2003).

a fund allowing market timing to exist may be violating representations in the fund's prospectus that market timing will not be allowed.

Both late trading and market timing activities injure the funds and their investors because the funds lose money to the arbitrage activities of the traders and because the funds often will have to retain additional cash in order to be able to pay these traders when they sell their shares.

The SEC has urged funds to enhance their compliance procedures regarding market timing, and is pursuing market timing enforcement actions.[18] It has proposed amendments to the registration form used by mutual funds to register securities for sale that would require funds to disclose risks to them of market timing and to disclose fund policies and procedures designed to prevent market timing.[19] It has also recently required funds to adopt policies and procedures dealing with market timing.[20] Some funds are attempting to meet market timing problems by adopting special valuation procedures for foreign securities, and the SEC has proposed that funds disclose their fair value procedures.[21] *No legislation is needed in the market timing area at this time. The SEC should adopt its proposed disclosure rules and should consider rules requiring third-party distributors to monitor market timing practices.*

Prospectus Disclosures

Sales of fund shares to investors are regulated by the Securities Act of 1933, which mandates disclosures when selling securities to investors. Since sales of mutual fund shares are continually being made, the SEC allows the fund prospectuses to be amended on a continuous basis, so that they are always current.

Prospectus disclosures must be complete and truthful. By describing the types of portfolio securities that will be purchased by the fund, the use of leverage, the methods of distributions of fund shares, and costs to investors the funds are essentially making a series of promises to investors regarding fund operations.

Oversight of the adviser by the fund directors includes oversight of the adviser's responsibility to see that its activities conform to the representations made in each fund's prospectus. The SEC's recent rules requiring compliance policies and procedures and emphasizing the enhanced role of the chief compliance officer will provide the fund boards with tools for meeting these responsibilities.

Conclusion

In conclusion, I believe that Congress should rely upon the Securities and Exchange Commission to remedy problems in the mutual fund industry, particularly by measures designed to enhance the power of independent fund directors. Congress should not take any legislative action, except for repealing Section 28(e) of the Securities and Exchange Act.

PREPARED STATEMENT OF DAVID S. POTTRUCK

CHIEF EXECUTIVE OFFICER, THE CHARLES SCHWAB CORPORATION

FEBRUARY 26, 2004

Chairman Shelby, Ranking Member Sarbanes, distinguished Members of the Committee: My name is David S. Pottruck, and I am the Chief Executive Officer of The Charles Schwab Corporation, one of the Nation's largest financial services firms. Schwab was founded more than 30 years ago as a pioneer in discount brokerage. Today, we are a full-service firm serving more than 8 million client accounts with nearly $1 trillion in client assets. Through Schwab Corporate Services, we serve more than 2 million 401(k) plan investors.

I appreciate the opportunity to provide my thoughts this morning on the vitally-needed reforms to the mutual fund industry. Let me begin by assuring you that we stand ready to help the Committee move forward in any way we can. We at Schwab share the Committee's disappointment over the recent events that have propelled mutual funds to the front pages. We fully support many of the reforms already un-

[18] *E.g., In the matter of Putnam Investment Management, LLC.* Investment Advisers Act Rel. 2192 (November 13, 2003).

[19] Proposed Rule: Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings, Release 33–8343, IC–26287 (December 11, 2003).

[20] Final Rule: Compliance Programs of Investment Companies and Investment Advisers. Rel. IC–26299 (December 17, 2003).

[21] Proposed Rule: Disclosure Regarding Market Timing and Selective Disclosures of Portfolio Holdings. Rel. 33–8343, IC–26287 (December 11, 2003).

dertaken by the SEC. But we also believe that more can and should be done. I applaud this Committee's efforts to put the interests of investors—not insiders—first.

Introduction—The Importance of Mutual Fund Supermarkets

Schwab is certainly no stranger to the needs of mutual fund investors—mutual funds have long been at the core of our business. We launched the first mutual fund supermarket to focus on no-load funds some 20 years ago, and in 1992 we launched the first no-load, no-transaction fee supermarket, OneSource®. Today, Schwab clients can choose from among nearly 5,000 mutual funds from 430 fund families, including nearly 2,000 funds that have no loads and no transaction fees.

Our heritage is one of innovation, and I don't think I am being too bold when I say that mutual fund supermarkets have revolutionized investing for millions of Americans. Supermarkets have helped provide investors with an array of investment choices unimaginable a decade or two ago, when investors were essentially held captive by their fund company. Supermarkets empower investors by facilitating comparison shopping among funds; they simplify investing by consolidating statements and allowing investors to move easily from one fund family to another; and they increase competition, driving down costs for individual investors.

We made the decision early on to focus our supermarket on no-load, no-transaction fee funds because we felt that investors should not be forced to bear these costs, and that they deserved access to funds without them. But in response to client demand, we also make available more than 2,600 mutual funds that do carry either transaction fees or loads, or both. The goal of our supermarket is to make available to our clients the widest array of funds, and our customers have demanded the option of funds that carry additional costs. No two investors are the same. While the majority of our clients prefer funds without loads or transaction fees, that is a determination for each individual investor to make on his or her own, based on his or her own investment strategy, needs, and long-term goals. If a load fund offers superior service or performance, investors may determine that paying the load is worth those benefits. But fewer than 1 percent of all mutual fund purchases made at Schwab involve paying a load.

Our mutual fund supermarket is designed to make comparison shopping among funds as easy as possible. On our website, *Schwab.com,* investors can compare literally thousands of mutual funds in a wide array of categories to find the one that best meets their investment goals. They can compare the performance of a no-load fund with that of a load fund, to determine whether loads help or hinder market performance. They can compare funds that have transaction fees with funds that don't have transaction fees. They can compare multiple funds across any number of key data points—past performance, fee structure, portfolio turnover rates, the tenure of the fund manager, risk, amount of assets in the fund, even the percentage of holdings that are from a particular sector of the economy. All of these tools are designed with the idea that what is most important to one investor may be least important to the next. At Schwab, we strive to make as much information as possible available to the investor prior to the transaction to help him or her make the most educated decision.

It is clear to us that our supermarket strategy was the right one. Our clients love this kind of freedom, convenience, and flexibility, and they have voted with their wallets. Before the launch of our no-load, no-transaction fee marketplace, our clients held about $6 billion in mutual funds. Today, our clients have more than $235 billion invested in literally thousands of mutual funds from more than 400 fund companies. We are proud to be one of the largest mutual fund supermarkets in the world.

And it's not just Schwab's supermarket that investors have responded to. The vast majority of mutual fund trades today are executed via a supermarket, whether it be Schwab's, or Fidelity's, or another competitor's. Only about 12 percent of mutual fund assets are purchased directly from a fund company. And, in the retirement plan context, an estimated 80 or more percent of all 401(k) investors have access to a fund supermarket that allows them to compare hundreds or even thousands of funds across hundreds of fund families to find the one that best meets their individual needs, goals, and style.

Mutual fund supermarkets have also helped the industry remain extraordinarily competitive. In a time of growing consolidation in the financial services industry that has resulted in less consumer choice, mutual funds stand out as an admirable exception. Since 1990, the number of mutual funds available to investors has nearly tripled—from 3,000 to over 8,000. Many of these new funds are managed by smaller fund companies that didn't even exist a decade ago—and could not exist without the infrastructure provided by mutual fund supermarkets that helps them reach large numbers of individual investors.

In short, supermarkets are a crucial innovation that provide the link between millions of Americans and our equity markets. They are an indispensable tool that must be preserved and strengthened—not weakened by reform proposals, no matter how well-intentioned. As the Committee considers reform, I urge it to remember the very qualities that make mutual fund supermarkets so valuable to investors: Choice, simplicity, convenience, transparency, and competition.

Reforms Must Preserve the Strength of Supermarkets

Let me briefly outline a few suggestions for the Committee's consideration that underscore these principles.

First of all, it is clear that there is not enough transparency in the mutual fund business. Schwab supports many of the proposals under consideration in Congress and at the SEC to enhance disclosure to fund investors, but I think we can go further. There are three areas that I would recommend for additional disclosure:

- Investors have a right to know if their broker's representative has a financial incentive to push one mutual fund over another. No one at Schwab does. We voluntarily provide information on our website today to investors about how our representatives are paid and rewarded. All investors deserve this transparency.
- Investors need to know whether a fund company has paid a fee to be on a broker's preferred list. At Schwab, our OneSource Select List™ features the best performing no-load, no-transaction fee funds available through Schwab's supermarket. No fund can pay us for inclusion on the list, and we tell investors that. More light needs to be shed on how these lists are created.
- To bolster competition and lower prices, Congress should unfix sales loads, so that broker-dealers are forced to compete, just like back in 1974, when commissions were deregulated. Mutual funds should be allowed to set a maximum load, but not a minimum. This would put the burden on the broker to determine, disclose, and defend their commissions. Investors could then shop around for the best price. Mutual funds already compete vigorously on the fees they charge investors; there is no reason that broker-dealers should not do so as well.

  Moreover, in 1992 the SEC's Division of Investment Management recommended that the Commission seek legislation to amend Section 22(d) of the Investment Company Act, which mandates retail price maintenance on mutual fund sales loads.[1] That recommendation was never adopted, and as a result, investors are faced today with a confusing array of load share classes that prevent too many investors from understanding how they are paying for their sales commission—via a front-end load, a back-end load, or level load. The proliferation of Class A, B, and C shares leads to conflicts, as brokers could push investors into a class that may not be appropriate for their situation. If Congress acted to unfix sales loads, the SEC should do away with the confusing proliferation of load share classes.

All of these steps would put investors in the driver's seat—helping them better understand what they are paying for and giving them better tools for making informed investment decisions.

It is critically important, though, that we focus on the quality not just the quantity of these disclosures. Mutual fund documents are already too complex. They are littered with legalese and fine print that too few investors can understand, when they bother to read it at all. There is a danger that additional disclosure will further overwhelm investors. The SEC has made important progress in recent years in its plain English initiatives—it should apply those principles here as well, ensuring that new disclosures are presented as simply and as conspicuously as possible, and that they facilitate comparability and clarity.

"Hard 4 p.m. Close" Will Harm Investors

Unfortunately, Mr. Chairman, one of the highest-profile proposals to emerge from the SEC would undermine all of these efforts. The so-called "Hard 4 p.m. Close" represents a step backward for investors. While well-intentioned, it does nothing to increase transparency, minimize conflicts, or maximize convenience. Instead, it undermines the goal of competition and would deprive investors of choice.

The SEC proposal would require all fund orders to be received by fund companies by Market Close, generally 4 p.m. Eastern time, to receive that day's price. To accomplish that, intermediaries, such as Schwab, would have to impose an earlier cut-off time, perhaps at 2:30 or 3 p.m., to process, verify, and aggregate those orders before submitting them to the fund company. Furthermore, because of the addi-

[1] See *Protecting Investors: A Half Century of Investment Company Regulation,* Division of Investment Management, SEC, at page 297.

tional regulatory requirements surrounding the processing of retirement plan trades, an even earlier cut-off time would have to be imposed for retirement plan participants. The result is a confusing array of different rules depending on how the individual invests.

In considering the impact of the "Hard 4," it is important first to understand how mutual funds transactions currently work. At Schwab, we receive mutual fund orders throughout the day and night from individual investors, registered investment advisers, clearing firms, and retirement plan administrators. Those orders come in to live representatives, via our website, over the telephone, even via wireless communication devices. Close to 90 percent of our orders are received through the electronic channels with minimal or no human intervention. Whenever and however those orders are placed, they are promptly entered into our system and electronically time-stamped. Our system automatically and in real time aggregates the order for the appropriate day's price. Orders received up until Market Close automatically receive today's price; orders received after Market Close automatically receive the next day's price.

Once the market closes, Schwab engages in a review process to ensure the accuracy and integrity of our aggregate omnibus orders prior to sending them to the funds. For the majority of our mutual fund business, orders are aggregated by order type and are transmitted as a single omnibus level order to the fund. Aggregating the orders provides real economic value and minimizes the expenses to us and the funds. We also use this small window of time to proactively notify fund companies of any large purchase and redemption orders from clients. This gives fund companies the time needed to contact their portfolio managers and make an informed decision regarding the order (taking into account client trading behavior, fund flows, and market conditions) and communicate back to Schwab. Schwab also needs time to cancel the order(s) if the fund elects to reject the purchase. Since a rejected order may involve multiple orders for hundreds of accounts managed by a registered investment adviser, the process of canceling a rejected order may take upwards of 30 minutes. This is important since we do not want to transmit orders that have been rejected by the fund. This ultimately protects the funds (and Schwab) from the operational and financial risks associated with canceling orders that have been rejected after they were transmitted to the funds.

Typically, this entire review process is completed within 60 to 90 minutes and our omnibus orders are submitted to the various fund companies between 5 and 5:30 p.m., Eastern time. For many intermediaries, the process takes much longer, and orders are submitted to fund companies well into the night. It is, of course, this gap in time, between 4 p.m., when the market closes, and the time when orders are submitted to the fund company, that the SEC has identified as the period some have taken advantage of to engage in the prohibited activity known as "late trading." The "Hard 4" solution proposed by the SEC is an attempt to deal with this problem.

We at Schwab share the Committee's disappointment at the illegal late trading activity that has been uncovered in the industry, and we strongly support regulatory and legislative steps to ensure that this kind of activity is eliminated. We have a proposal, which we call the "Smart 4" solution, that I outline below. It is a solution that cracks down on late trading without disadvantaging different groups of investors. Before I detail that proposal, which we believe is the best solution, let me take a moment to walk the Committee through the impact of the SEC's "Hard 4" proposal on various groups of investors:

- *Impact on Individual Investors.* As the SEC acknowledges in its rule proposal, substantial changes would be required in the way fund intermediaries process fund purchase and redemption orders. Today, a mutual fund may accept an order *after* Market Close, provided the order was received by an intermediary *prior* to Market Close. However, under the Proposed Rules, investors investing through intermediaries would be required to submit purchase orders prior to an earlier cut-off time, such as 2 p.m., to allow the intermediary sufficient time to process the purchase and the redemption orders before submitting them to the fund, its designated transfer agent, or a registered clearing agency by the 4 p.m. deadline. Significantly, that earlier cut-off time would likely be different for different intermediaries, depending on the business model and systems capabilities of the particular firm. In other words, an investor who uses Schwab might have a deadline of 2:30 p.m., but an investor that uses Firm ABC as an intermediary might have a cut-off time of an hour earlier. Of course, an investor would be able to place an order directly with a fund company right up until 4 p.m. Yet approximately 88 percent of mutual fund purchases today are executed via an intermediary. Undoubtedly, this variety of cut-off times would be confusing to investors, and it would create different classes of investors depending on which firms they used to execute their trades.

Moreover, earlier cut-off times would particularly disadvantage investors on the West Coast and in Hawaii. For example, West Coast investors might be required to submit their mutual fund orders to the intermediary by 11 a.m. Pacific Time (and as early as 8 a.m. in Hawaii) to receive that day's current price (assuming a 2 p.m. Eastern time early cut-off time).

Let me also make an observation about the nature of pricing mutual funds. Forward pricing in the fund industry has been necessary to protect existing shareholders, but the reality is that it is not a particularly consumer-friendly feature. Where else does a consumer make a decision to buy something without knowing the exact price he/she will pay? Mutual fund investors are promised only that they will get the appropriate price at the next calculated time. Investors don't like this uncertainty, and they take steps to minimize it by placing orders later in the day when there is less time between when their order is entered and the pricing time. In fact, over 40 percent of mutual fund orders are received by Schwab during the last 2 hours prior to market close. Sadly, the Hard 4 p.m. Close will create increased investor dissatisfaction by increasing the time between order placement and pricing. We owe it to investors to do better, not worse.

- *Impact on Retirement Plan Participants.* More significantly, retirement plan participants, because of the increased complexity of aggregating and pricing orders at the individual and plan levels, would have even earlier, less convenient cut-offs than ordinary retail investors. The latest order cut-off a retirement plan could administer likely would be 12 p.m. Eastern time. In practice then, as acknowledged by the SEC in its proposal, almost all retirement plan participants would as a result receive next-day pricing, not same-day pricing.

  The proposal would have other unfortunate consequences for retirement plans. Under the proposed rules, retirement plans will face strong pressure to offer choices only from a single fund family, which would allow orders to be placed up until the market closes. In this way, retirement plans will be able to take participant orders later than if the orders were first routed through an intermediary such as a broker-dealer. However, limiting plan participants to a single fund family will be a detriment for 401(k) plan participants. It will reduce choice and the ability to diversify retirement assets across multiple fund families. Reducing participant choice will encourage higher operating expense ratios and other costs. As a result of reduced choice and increased costs, plan participants could face increased risk and decreased returns.

  Forcing retirement plan participants to get next-day pricing would also raise serious fiduciary issues for retirement plan sponsors as to whether they should offer mutual funds as an investment option at all, when other pooled investment vehicles (such as bank collective trust funds and insurance company separate accounts) with same-day pricing are available as alternatives. It would be unfortunate if the "Hard 4" proposal created an incentive for 401(k) plan participants, who include less sophisticated investors, to receive investment choices with a lower level of investor protection.

  One of the issues that frustrates me most in this context is the claim that retirement plan participants are, or at least should be, long-term investors, for whom the price of a mutual fund on a particular day is not that important. While the effect of next-day pricing on a single investor may be small, the aggregate effect on all investors is large. SEC statements over time on best execution (in the equities context), for example, make clear the SEC's view that it is a serious breach of fiduciary duty to short-change investors by a few pennies per share. In the aggregate, especially over long periods of time, pennies matter.[2] Long-term investors should be fully invested; systematically having money uninvested for a day will increase long-term tracking error and disadvantage investors (especially since significant market events will occur on some of the uninvested days). Furthermore, it will undermine 401(k) plan participants' confidence in mutual funds if they are forced to wait an extra day to sell in a falling market, or to buy in a rising market. The Government should not be in the business of determining what is and is not an "appropriate" investing strategy for a retirement plan participant.
- *Impact of an Early Order Cut-Off on Investors' Use of Intermediaries.* Another disadvantage of the "Hard 4" proposal is that it will create a strong disincentive to invest in mutual funds through intermediaries, which benefit investors in many ways. As I have already detailed, intermediaries are more convenient for investors. They allow clients to see all of types of assets, including mutual funds from

[2] See Remarks of Chairman Arthur Levitt, Best Execution: Promise of Integrity, Guardian of Competition (November 4, 1999); Order Execution Obligations, Securities Exchange Act Release No. 37619A (September 6, 1996).

different fund families, equities, bonds, and other investments, on a single web page and/or a single statement; enhance clients' ability to comparison shop among different fund families and make more informed decisions; foster more robust competition in the industry; and allow investors to move money more easily from one fund family to another. The SEC staff has repeatedly noted the benefits to investors of fund supermarkets, as recently as in a letter to the House Financial Services Committee last summer. [3]

- *Impact of Early Order Cut-Off on Funds—Cost and Competition.* By discouraging the use of intermediaries and encouraging direct investment with funds, the proposed "Hard 4" would result in all funds having to build more infrastructure for handling customer service and orders. Today, most fund companies receive a relatively small number of orders—the work of aggregating thousands of customer orders (and doing all of the attendant sub-accounting) occurs at the broker-dealer, not at the fund company. Many intermediaries, such as broker-dealers, find it more efficient to build this infrastructure, where they can leverage the infrastructure they already have for handling orders for other types of securities.

  Requiring an early order cut-off for mutual fund orders through intermediaries will create additional competitive distortions. Newer, smaller, more entrepreneurial mutual funds primarily reach clients through intermediaries and typically do not have the scale to reach clients directly. If the SEC adopts regulations that discourage the use of intermediaries, the result may be higher barriers to entry for new funds and fewer choices for investors. As a result, the mutual fund industry will move toward an oligopoly of large fund complexes with the size and scale to be able to reach investors directly. The inevitable result of lessened competition will be higher costs and fewer choices for investors.

  Moreover, mutual funds are just one choice among many other types of investments. An earlier cut-off time that applies only to mutual funds would disadvantage these funds compared to investors in competing products that will continue to have later cut-off times. Equities, exchange-traded funds (ETF's), closed-end funds, bank collective trust funds, insurance company separate accounts, and managed accounts will continue to accept orders up until 4 p.m. A "Hard 4" for mutual funds would encourage investors to prefer those products to mutual funds. Many of these other products are less regulated and have less robust disclosure.

"Smart 4"—A Strong Alternative That Will Protect, Not Harm Investors

Mr. Chairman, the term "Hard 4" is accurate—it will make investing harder. We prefer an alternative, a "Smart 4," if you will. It would utilize the best technology, enhanced compliance and audit requirements, and vigorous enforcement to stamp out late trading. The SEC included in its recent rule proposals an alternative proposal that incorporates several of our suggestions, but we would recommend going even further. Our "Smart 4" proposal would allow a fund intermediary to submit orders after Market Close, provided that the intermediary adopts certain protections designed to prevent late trading:

- Immediate electronic or physical time-stamping of orders in a manner that cannot be altered or discarded once the order is entered into the trading system.
- Annual certification that the intermediary and the fund has policies and procedures in place designed to prevent late trades, and that no late trades were submitted to the fund or its designated transfer agent during the period.
- Submission of the intermediary to an annual audit of its controls conducted by an independent public accountant who would submit their report to the fund's chief compliance officer.
- SEC inspection authority over any intermediary that seeks to submit orders it has received prior to 4 p.m. to the fund company after the market closes.
- Enhanced compliance surveillance policies and procedures that would ensure that orders were in fact received prior to 4 p.m.

We believe that any intermediary that seeks to submit orders that it received from its customers prior to 4 p.m. to the fund company after that hour should be required to adopt the five protections set forth above. Intermediaries should have the option, however, to avoid adopting these protections if they elect to submit their orders to the fund company prior to 4 p.m. This approach will be more effective in preventing instances of late order trades, while avoiding the many hardships that forcing an earlier cut-off time would impose on millions of mutual fund investors.

[3] See Memorandum from Paul F. Roye Re: Correspondence from Chairman Richard H. Baker, House Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, June 9, 2003, at 73; Investment Company Institute, 1998 SEC No-Act LEXIS 976 at *6 (publicly available October 30, 1998).

Schwab believes that the most effective way to stop late trading at both the fund level and the intermediary level is to make the time that a customer submits an order transparent to the fund, its independent auditors, and SEC examiners, and subject the order process to strict compliance controls, certification requirements, and independent audit and examination. This verifiable, "Smart 4 p.m. Close," provides a greater level of protection because it applies to all mutual fund orders, while avoiding the hardship on individual investors imposed by the "Hard 4 p.m. Close." Let me set forth further details about each of the five elements of this plan:

- *Electronic Audit Trail.* The mutual fund industry should work together to establish an enhanced electronic audit trail for mutual fund orders. Ideally, this audit trail should document the time of receipt of the order from the client, the time of transmittal within a firm (for example, from a branch or call center to a mutual funds operations group), the time of transmission among intermediaries (for example, from a retirement plan third-party administrator to a broker-dealer), and the time of transmission from the intermediary to the fund or its transfer agent. At an absolute minimum, however, the time of receipt of the order from the client should be captured electronically with the order secured from being altered. In addition, the time stamping should be accompanied by information about the actual individual who handled or observed that step in the process. Material modifications would require the cancellation of the original order and the entry of a new order with a new and updated time stamp.
- *Annual Certification of Procedures.* Entities that handle mutual fund orders—including fund companies and their transfer agents, as well as intermediaries such as brokerage firms and retirement plan third-party administrators—should issue annual certifications that they have procedures reasonably designed to prevent or detect late trading, and that those procedures have been implemented and are working as designed. Intermediaries would make these certifications available to any mutual fund on behalf of which it accepts orders for purchase or sale of shares of the fund. As is typically the case for certifications under the Sarbanes-Oxley Act of 2002, each entity would be responsible for designing a process to give the individuals signing the certification a reasonable basis for believing it to be correct. As with the SEC's recent proposal for investment company and investment adviser compliance programs, the annual certification process would address whether changes are needed to assure the continued effectiveness of the late-trading procedures.
- *Enhanced Auditor Review.* All entities that handle mutual fund orders should be required to conduct an annual auditor review of their late-trade prevention and detection procedures. For registered intermediaries such as broker-dealers or banks, we suggest, at a minimum, a standardized SAS 70 or similar review by independent auditors. An audit review would be based in part on the annual written compliance certification by the intermediary's management discussed above, which would in this context serve as the equivalent of a management representation letter for an auditor review. Both the management certification and the results of the auditor review should be provided to the funds on behalf of which the intermediary accepts orders. Further, if the auditors discover any material control weaknesses, and management does not promptly correct those weaknesses, the auditor should be required to escalate that information to the SEC, similar to the requirement for independent audit escalation under Section 10A of the Securities Exchange Act of 1934.
- *Consent to SEC Inspection Jurisdiction.* The SEC should be able to inspect any intermediary to review whether its late-trade prevention and detection procedures are adequate and are working as designed. The SEC already has jurisdiction to inspect broker-dealers who process mutual fund orders; but there should be consistency in oversight. The SEC should require banks and trust companies to "push out" mutual fund order processing activities to an affiliated broker-dealer registered with the SEC. The Gramm-Leach-Bliley Act contemplated that these types of securities processing activities (a core part of the definition of broker-dealer activity in the Exchange Act) would be handled by broker-dealer affiliates; however, regulations implementing this portion of Gramm-Leach-Bliley do not exist. Alternatively, the SEC could require that banks register as transfer agents to engage in this type of mutual fund order aggregation and processing.

  Unregistered intermediaries should consent to SEC inspection on the grounds that they are acting as an agent of an SEC-registered mutual fund when they accept orders for that fund. Indeed, some third-party administrators are already subject to SEC jurisdiction as registered sub-transfer agents for fund companies. To the extent intermediaries decline to consent to SEC jurisdiction for inspections,

they should be required to submit all trades to a registered intermediary (or directly to the fund or transfer agent) prior to Market Close.

- *Enhanced Compliance Surveillance.* Even with an electronic order audit trail, there may be situations where the electronic version of the order is entered shortly after the market closes (for example, when a client calls just before 4 p.m. but the registered representative does not finish inputting the order until shortly after 4 p.m., or when a computer systems problem delays electronic input of the order). A robust compliance surveillance process can address the potential for abuse of this process. Firms should require surveillance for suspicious patterns of potential late orders by a single client, orders entered by related clients (such as clients of a single adviser), or orders entered by a single registered representative. Where suspicious patterns exist without adequate contemporaneous explanations, firms should take prompt actions to investigate and respond appropriately.

In addition, each intermediary's handling of late orders should be transparent to the regulators. Funds and intermediaries who accept customer orders up until 4 p.m. should file annually with the SEC a report of trade activities including reporting of any "late trades" with explanations. This reporting would allow visibility and oversight by the SEC without overwhelming the Agency with the need to inspect or examine each firm: The SEC could target firms where the late trading filings indicate unusual activity. This process already exists for transfer agents in the current TA–2 filing. Finally, funds and intermediaries should be required to review late trading policies and procedures with their employees in their annual compliance continuing education meetings.

Mr. Chairman, this "Smart 4" proposal is, we believe, the most effective way to combat the pernicious problem of late trading. It is a tough and sensible solution that will prevent illegal activity but without disadvantaging legitimate investors who want nothing more than to make very sound investment decisions on a level playing field.

Other Issues

With the Committee's indulgence, I would like to conclude by offering specific comments on two other issues that have been under the spotlight recently.

Fees

There has been considerable discussion in the media and at the Senate Governmental Affairs hearing last month about the subject of mutual fund fees. Some believe that the Government should be mandating fee rates or capping fee rates. I strongly disagree. This is an extraordinarily competitive industry, which puts tremendous pressure on companies to keep fees low. As an investor, if you believe the fees a particular fund charges are too high, you have literally thousands of other funds to choose from. Every investor is different and should be allowed to make his or her own choices—if a particular fund has a high fee but offers tremendous performance and tremendous service, then an investor can make the decision to pay for that. Neither Congress nor the regulators should be in the business of mandating fee levels in such a competitive environment.

The other point I want to raise is the issue of how best to disclose fees. In both the legislative and the regulatory context over the past few months, there has been considerable discussion of what kind of disclosure is most appropriate and useful to investors. One idea under consideration is mandating personalized, actual-dollar disclosure of the fees each unique investor pays. I am not convinced that this kind of individualized disclosure is actually helpful to investors. First of all, it would be enormously expensive, and firms would just pass that cost on to investors, increasing the fees. More importantly, I do not believe individualized disclosure facilitates the kind of apples-to-apples comparisons that investors need. Apparently, the SEC agrees, for Commissioners approved a rule earlier this month requiring that funds disclosure, via a standardized example, what the fees are on an investment of $1,000. This was a sensible decision by the Commission, as it allows for quick side-by-side comparison of different funds, would be a much better solution. We applaud the Commission for moving so quickly on this rule.

Mutual Fund Governance

On the issue of mutual fund governance, we support the SEC's proposal for mutual fund boards to have a 75 percent majority of independent directors. We have concerns, however, about mandating an independent chairman. We believe the independent directors should be empowered to choose whomever they want as a chairman, and that person can be independent or interested. There does not seem to be a correlation between behavior and having an independent chairman. Indeed, many of the funds that have had the worst problems over the last few months had an

independent chairman. Finally, let me say that Charles R. Schwab is the Chairman of our mutual fund board. We believe the expertise and experience he brings to the table is unparalleled. Moreover, we believe his integrity cannot be questioned, and that his long history of championing the individual investor speaks for itself.

Conclusion

As we move forward we must remember the lessons we have learned from the evolution of mutual fund supermarkets. We must empower investors by promoting competition and choice; requiring clear, simple disclosure; and minimizing conflicts. Investors have given us a roadmap that should guide our reform efforts. We should also look ahead to solutions that may be further down the road, such as examining ways to use technology to improve pricing and, perhaps ultimately, to get to more frequent, even real-time, pricing.

I applaud this Committee for its deliberate approach on this issue. Mutual funds are the great democratizing force in our markets. They are the vehicle that allows millions of Americans to participate fully in our Nation's economic prosperity. However, any reform that confuses investors or erects new barriers for those who want to participate in mutual funds—including well-intentioned proposals such as the "Hard 4 p.m. Close"—will be a step backward, not forward.

Finally, Mr. Chairman, let me conclude by saying that we in the mutual fund industry bear the ultimate responsibility for acting in the best interest of our clients. Legislation and regulation can only do so much. Most of the failures that have been publicized were not about inadequate rules, but a failure to follow the letter and spirit of the rules we have. At Schwab, we are committed to living by the principles I have outlined for you today.

I appreciate the opportunity to share my views on this critical issue and I would be happy to answer in writing any follow-up questions Members of the Committee may have. Thank you.

PREPARED STATEMENT OF MELLODY HOBSON

PRESIDENT, ARIEL CAPITAL MANAGEMENT, LLC/ARIEL MUTUAL FUNDS

FEBRUARY 26, 2004

Thank you, Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee. I am honored to be here today. The issues facing mutual fund companies demand serious and thoughtful attention from industry leaders, mutual fund regulators, and from the Members of this Committee. An appalling breach of trust by some in the fund industry has raised doubts about the industry's commitment to integrity—a commitment that hundreds of mutual fund companies and tens of thousands of fund employees have spent more than 60 years building. As such, I sincerely thank you for allowing me the opportunity to testify.

I particularly welcome the chance to speak on behalf of hundreds of small mutual fund companies, and applaud the Committee for its thoughtful consideration of our special concerns.

I am the President of Ariel Capital Management, LLC, which serves as the investment adviser to the Ariel Mutual Funds, a small mutual fund company based in Chicago. By way of background, our firm's Chairman, John W. Rogers, Jr., founded Ariel over 21 years ago at the young age of 24. John's exposure to the stock market began when his father started buying him stocks every birthday and every Christmas instead of toys starting when he was just 12 years old. Ultimately, his childhood hobby evolved into his life's work—a passion that led to the creation of our firm.

It is also worth noting that at the time of our inception in 1983, Ariel was the first minority-owned money management firm in the United States. In many ways, you can say we are a testament to the American Dream. John and I certainly feel that way.

In part because of our pioneering status, we work particularly hard to reach out to those who have not experienced firsthand the wonders of long-term investing, compound growth, and the creation of enduring wealth. To this end, I also serve as the financial contributor for a national network news program. Besides educating all investors, our unique mission is also to make the stock market a regular part of dinner table conversation in the Black community.

Ariel's four no-load mutual funds hold about $5.5 billion in assets and serve approximately 280,000 investors. So clearly, our responsibilities to investors are quite large. But it should be just as clear that as a company, in comparison to the largest mutual fund firms, we are quite small. Ariel has a total of 74 employees.

I think it is important for the Committee to be aware that small mutual fund companies are the norm in our industry, not the exception. In fact, more than 370 mutual fund companies in the United States manage $5 billion or less. Perhaps the point is stronger if you consider it from a different perspective. If you combined all the assets of these 370 smaller mutual fund companies that manage $5 billion or less into a single firm, we would still be a little less than half the size of the Nation's largest mutual fund company.

Clearly, there are important ways in which Ariel and other small, entrepreneurial mutual fund firms stand far apart from the giants in our industry. Yet, because of our vision and hard work—and because of regulatory innovations like the SEC's Rule 12b–1—we are able to compete fiercely and often quite successfully with larger fund companies every single day. In this way too, you can say Ariel is a testament to the American Dream.

The revelations about trading abuses involving mutual funds are extremely painful. I am, of course, profoundly disappointed about the abuses that have occurred at mutual funds. Ariel is 100 percent committed to supporting effective reforms that ensure these abuses will not happen again. I am greatly concerned that mutual fund investors have had their confidence shaken and my life's work has been threatened by individuals motivated by their selfish, shortsighted interests.

Nevertheless, I think it is important to tell you that I still take enormous pride in being part of a great industry. I do not believe that most mutual fund companies ignore their fiduciary obligations, have lost their connection to their customers or abandoned the basic principles of sound investment management. In fact, I believe nothing could be further from the truth. As a mutual fund executive, I know my future, my credibility, and my livelihood are inextricably linked to the success of Ariel shareholders.

The fundamental obligation of a mutual fund company is to provide dependable, cost-effective, long-term investment products. This is no small feat considering the destinies of average Americans and the capitalist system itself is at stake. Each day, my firm, Ariel, strives to do just that. I strongly believe the overwhelming majority of the Nation's mutual fund companies work to do the same.

Regarding the three areas I have been asked to address today, I would like to emphasize the potential affects on small mutual fund companies like Ariel.

Fees

First, I would like to address the costs and fees borne by mutual fund shareholders. In order to adequately discuss this issue, it is important for policymakers to understand not just the sum of mutual fund fees, but also the parts.

A shareholder in a mutual fund is unique. No matter how much is invested, each receives equal access to all of the benefits the mutual fund offers—diversification, professional management, liquidity, and simplicity. For example, Ariel investors who invest $50 per month are afforded the same benefits as those who have multimillion accounts.

Industry critics claim mutual fund fees are excessive when compared to management fees of pension funds and other institutional accounts. This argument is incomplete and wrong. Comparing the fee structure of an institutional account to a mutual fund is like comparing an apple to an orange. In fact, despite some surface similarities—mainly the offering of investment management services—the organizational, operational, legal and regulatory frameworks for mutual funds versus institutional accounts could not be more different.

More specifically, total costs for a mutual fund investor include a litany of services that are not commonly offered to institutional investors. These services have been developed to increase shareholder access and knowledge. They include phone centers with licensed service representatives made available to answer any questions; websites that often provide 24-hour account access; compliance, accounting, and legal oversight; as well as development of everything from the prospectus to the shareholder letter that keep investors informed about how their funds are performing.

In contrast, the management of an institutional account generally only calls for portfolio management and a letter detailing performance. As opposed to the investment manager, the pension plan sponsor generally is responsible for legal, regulatory, and participant communication. The ICI recently completed an excellent study of this question. I have attached a copy of it to my testimony as Appendix 1, and commend its key findings to you. Among the most important is the fact that, when you adjust for the substantial differences between managing mutual funds and pension plan portfolios, the costs of the two are essentially identical.

Fee differences aside, the total amount mutual fund shareholders are being charged, contrary to what some claim, has decreased. The SEC, GAO, and ICI have

all found that substantial majorities of mutual funds lower their fee levels as they grow, which is the very essence of economies of scale.

In addition, the ICI has found that since 1980, the average cost of owning stock mutual funds has decreased by 45 percent; bond funds, 42 percent; and money market funds, 38 percent.[1] Not to mention, because of the great deal of competition in our industry, investors can, and do, vote with their feet. This is clear from the fact that 87 percent of the assets shareholders have invested in stock mutual funds are in funds whose fees are lower than the industry average. Stated differently, the typical investor's equity mutual funds have total annual expenses of just 1 percent, which is nearly 40 percent less than the fees charged by the average fund. The SEC reached similar conclusions in the mutual fund fee study they completed in 2000.

When an investor buys a fund, they receive a prospectus with a fee table listed within the first pages which details total cost. A critically important part of the fee table is the mandatory, standardized example it includes that illustrates the costs an investor can expect to pay over a 1-, 3-, and 5-year period given a $10,000 investment. This example enables investors to make exact apples-to-apples comparisons of the total costs of any of the 8,000 mutual funds in the country.

It is for some reason neglected in many of the media reports I see on mutual fund fees, but the fact is that the fee table was redesigned by the SEC in 1998 following the most extensive testing with investors ever undertaken by the Agency. Multiple focus groups were sponsored to determine how to make the fee table as accessible and useful as possible. And both the SEC and GAO have since testified before Congress that the fee table is an extremely useful and accurate way to compare the costs of competing mutual fund investments. The SEC has made the further point, which again is frequently overlooked, that the fee table provides a form of disclosure to investors that is superior to what is offered by all other financial services.

A significant mutual fund fee issue that has been frequently misunderstood relates to a component of the fund expense ratio called the Rule 12b–1 fee. This issue is of great importance to small mutual fund companies like Ariel, and impacts our ability to distribute funds to investors. The easiest way to think about mutual fund distribution is to equate it to distribution in the film industry. You may be an inspired director and have made a great movie, but if you do not have a distributor, no movie theaters will get copies of your film and most individuals will never have a chance to see it.

The same is true of mutual funds. You can have a terrific, well-managed mutual fund with an excellent track record. But if the fund company does not have access to wide sources of third-party distribution, it will most likely be a fund without investors. Third-party firms with the scale to offer small mutual funds access to broad distribution channels obviously must be paid for their services. Rule 12b–1 fees have been absolutely critical to our effort to expose many small mutual fund companies like Ariel to millions of potential investors around the country.

Finally, on the subject of fees, the mutual fund industry is the only industry I know of where price increases are rare. In order to raise its management fee, a fund company must first get a majority of all fund directors to agree. They must then get a majority of the independent directors to separately vote in favor of the increase. Those steps alone are insufficient: The fund company must ask its shareholders to vote on the increase, and a majority is required for the proposed increase to take effect.

For this reason and others, price regulation of mutual funds would be directly counter to the principles of capitalism. With over 500 mutual funds companies and nearly 8,000 mutual funds, investors have choice. Federal regulation of prices is often necessitated when there are few competitors and so little choice that the opportunity for monopolistic practices is a threat to the consumer. This is not the case in our industry.

Governance

Second, the issue of board governance is worthy of some discussion given the recent push to mandate independent chairs for mutual fund boards. While we do have an independent board chairman at Ariel Mutual Funds, I would argue the designation is irrelevant based upon the unique way in which mutual funds are governed. More specifically, independent directors already make all of the major decisions affecting the funds they oversee. For example, independent directors have the exclusive ability to renew the investment manager's advisory contract, which is clearly one of every mutual fund's largest annual expenses. A full review and renewal of this contract must take place each and every year. Independent directors

[1] "The Cost of Buying and Owning Mutual Funds," Investment Company Institute, Volume 13, No. 1, February 2004.

also have extensive authority with respect to hiring and retaining firms that provide key services to the fund, such as the fund's outside auditor. Additionally, independent directors are solely represented on board nominating committees—leaving affiliated or inside directors little say in the board's ultimate composition. Finally, as both the SEC and GAO testified in June of last year, once boards are composed of a majority or super-majority of independent directors—as most funds already are—the independent directors are fully empowered to dictate who the chairman of the board will be.

Another governance-related point worthy of discussion is the newly enacted requirement pertaining to fund company boards and the hiring of a compliance officer. I certainly understand why the SEC and others—including the ICI—have looked to such a requirement in response to the abuses revealed in recent months. ICI President Matt Fink has said that he views this particular requirement as one of the changes most likely to have enduring benefits for funds and their shareholders.

We will defer to policy experts with respect to the likelihood that the compliance officer requirement will produce the hoped for benefits. But we urge everyone involved to also recognize the substantial disproportionate cost that requirements like this—and many others currently on the table or being discussed—will pose for smaller mutual fund companies. We obviously have much more limited resources than the small number of very large fund companies. Therefore, we hope you and the other policymakers are aware of the serious impact such requirements will have on our cost structure and on our competitive position within the industry. While obviously well-intended, rules of this nature could create a barrier to entry for future entrepreneurs—like my colleague John Rogers—interested in starting a fund company.

Disclosure

Federal Reserve Chairman Alan Greenspan recently observed, "[I]n our laudable efforts to improve public disclosure, we too often appear to be mistaking more extensive disclosure for greater transparency." [2]

Chairman Greenspan said that improved transparency is more important—but harder to achieve—than improved disclosure. "Transparency challenges market participants not only to provide information but also to place that information in a context that makes it meaningful." [3] Former SEC Chairman Levitt once expressed a similar concern, "[t]he law of unintended results has come into play: Our passion for full disclosure has created fact-bloated reports, and prospectuses that are more redundant than revealing." [4]

In a report to the House Financial Services Committee last June, the SEC reported that it had *adopted* 40 new investment company rules since 1998, averaging one every 7 weeks. The list the SEC developed is attached as Appendix 2. At the time this represented the busiest period of the SEC's mutual fund rulemaking in its history.

Since the first revelation of trading abuses on September 3 last year, the SEC has averaged one new regulatory action every 2 weeks. During this time, the SEC has adopted two additional mutual fund rule requirements, proposed nine new regulatory initiatives, and issued a concept release about whether to require a new form of cost disclosure.

I believe that in responding to new concerns and problems by simply calling for more disclosure, we risk impeding rather than enhancing decisionmaking by individuals. It is worth remembering that when the SEC overhauled mutual fund prospectuses 6 years ago, the simplified plain English prospectus was hailed as the most beneficial SEC change to disclosure requirements in the industry's 60-year history. At the time they adopted the new prospectus requirements, the SEC urged great caution about succumbing to the future temptations to add new disclosure requirements, noting that they had learned that too much information "discourages investors" from further reading or "obscures essential information" about the fund.[5]

Earlier, I mentioned I serve as an on-air financial contributor to a television network news program. I also author a bi-monthly column to aid investors. In these roles, I have literally received thousands of questions and requests for guidance. The recurring theme in these appeals for help is that people feel overwhelmed. Young, old, married, single, Black, white, working, or retired, investors want insight, time-

[2] "Corporate Governance," Remarks by The Honorable Alan Greenspan, Chairman, U.S. Federal Reserve Board, May 8, 2003.
[3] *Id.*
[4] "Taking the Mystery Out of the Marketplace: The SEC's Consumer Education Campaign," Remarks by The Honorable Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, October 13, 1994.
[5] *Id.*

savers, and ways to cut through the noise to get to the most important information that will help them make the best investment decisions. Rarely do I hear complaints about too little information. Instead, it is nearly always the opposite—investors drowning in data and in paper with no ability to assess what really matters. Interestingly, I have received many fairly sophisticated inquiries, but I have never received a question about some of the more esoteric fund company matters currently under review.

For these reasons, I respectfully suggest that the Committee concentrate a considerable part of its efforts in the weeks ahead on how we could clarify and increase understanding of the critical mutual fund information that is already disclosed to individuals. This Committee clearly recognizes from its past work that financial literacy is fundamental to any serious effort to empower investors to make the right choices that will secure their futures, as well as those of future generations.

At Ariel, we take financial literacy very seriously. We have partnered with Nuveen Investments to create an investment and financial literacy program at a Chicago Public School bearing our name. Through this effort, we award each first grade class a $20,000 gift that follows them through their grade school career. As the students progress through the school's unique investment curriculum, so does their involvement in the portfolio process and the management of their class fund.

The ICI has developed a major initiative with similar goals. Through its Education Foundation—the ICI created a program called Investing for Success Program. The program is a partnership with the National Urban League, the Coalition of Black Investors Investment Education Fund, and the Hispanic College Fund. Carefully designed programs have been presented in conferences and workshops across the country, on the Internet, and at historically Black colleges and universities.

We believe educational programs like these will help diminish the confusion and fear that shrouds the investment decisionmaking process and replace it with a culture of knowledge and confidence.

Conclusion

My colleagues at Ariel and in the fund industry are grateful for the Committee's efforts. When you find effective ways to reinforce investor protections and support the integrity of our markets, you help our business and our shareholders.

Recent events notwithstanding, it would be deeply regrettable if attempts to heighten mutual fund company oversight eroded the competitive position of small firms, one of the most dynamic and entrepreneurial parts of the fund business. For fund companies such as Ariel, it could seriously impair any efforts to enter and even remain actively engaged in this marketplace.

Similarly, I urge you to bear in mind the consequences for mutual funds overall if regulatory burdens increase so much that companies determine it is more attractive to them to market far less regulated investment products and services. I know that groups like Fund Democracy and the Consumer Federation of America share this concern, and I too think it merits your serious study.

Thank you again for the privilege of testifying. I look forward to your questions and appreciate your patience.

APPENDIX 1

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The Expenses of Defined Benefit Pension Plans and Mutual Funds

by Sean Collins[1]

INTRODUCTION

Previous research by the Investment Company Institute (ICI) has examined trends in mutual fund fees and expenses.[2] These articles provided evidence that the fees and expenses that mutual fund shareholders pay when purchasing and owning a mutual fund have declined considerably since the 1980s. These articles also found that the annual fees and expenses that an individual fund pays to operate tend to decline as its assets rise.

This paper extends the research of those earlier studies by comparing the expenses of mutual funds with those of defined benefit pension plans sponsored by state and local governments ("public pension plans").[3] Mutual funds and pension plans are similar in that they manage relatively large pools of assets.[4] Nonetheless, there are marked differences between mutual funds and pension plans. They have different business objectives, serve different clienteles, have different organizational structures and operations, and use different conventions for reporting expenses.

Failure to account for differences between mutual funds and pension plans can lead to misinterpretations. For example, a recent study by John Freeman and Stewart Brown (2001) concluded incorrectly that mutual funds pay more for portfolio management than public pension plans,[5] a result reached by including more than portfolio management expenses in the mutual fund fees that they analyzed.

This issue of *Perspective* examines the organizational structures of mutual funds and pension plans and compares levels and trends in their expenses. The major findings of the analysis are:

Organizational Structure

- Mutual funds and pension plans have markedly different business objectives and organizational structures. Mutual funds offer individuals professional portfolio management, risk pooling, diversification, and liquidity.

[1] Sean Collins is a Senior Economist at the Investment Company Institute. Adam Russell and Stefan Kimball assisted in collecting and analyzing the data. Ana Gonzalez prepared the charts and tables.

[2] See Brian K. Reid and John D. Rea, "Mutual Fund Distribution Channels and Distribution Costs," *Perspective*, Vol. 9, No. 3, July 2003 (www.ici.org/pdf/per09-03.pdf); "Total Shareholder Cost of Mutual Funds: An Update," *Fundamentals*, Vol. 11, No. 4, September 2002 (www.ici.org/pdf/fm-v11n4.pdf); John D. Rea, Brian K. Reid, and Kimberlee W. Millar, "Operating Expense Ratios, Assets, and Economies of Scale in Equity Mutual Funds," *Perspective*, Vol. 5, No. 5, December 1999 (www.ici.org/pdf/per05-05.pdf); and John D. Rea and Brian K. Reid, "Trends in the Ownership Cost of Equity Mutual Funds," *Perspective*, Vol. 4, No. 3, November 1998 (www.ici.org/pdf/per04-03.pdf).

[3] Throughout this article, except where noted, the term "pension plan" refers to a defined benefit pension plan, as opposed to a defined contribution pension plan.

[4] In total, mutual funds and pension plans manage nearly $10 trillion in assets.

[5] John P. Freeman and Stewart L. Brown, "Mutual Fund Advisory Fees: The Cost of Conflicts of Interest," *The Journal of Corporation Law*, Vol. 26, No. 3, Spring 2001, pp. 609–673.

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Pension plans are pooled investments that employers use to provide employees with a guaranteed income in retirement and are akin to life insurance products.

Mutual funds and pension plans operate under dissimilar legal and regulatory frameworks, and they offer different services to their clients.

Differences in Expense Structures

Owing to differences in organizational structures, mutual funds and pension plans report and account for their expenses in dissimilar ways.

Freeman and Brown's (2001) comparison of portfolio management expenses of pension plans and mutual funds illustrates the importance of allowing for differences between the two organizations. Their study compares expenses incurred by public pension plans for third-party portfolio management with the so-called "management fees" paid by mutual funds. The management fee of a mutual fund not only covers portfolio management, but also business and administrative services required to operate the fund. Therefore, not surprisingly, Freeman and Brown found that the fees pension plans incur for portfolio management are lower than the management fees of mutual funds. However, that finding says little about the relative costs that the two entities incur for portfolio management.

This article provides a more accurate comparison, weighing the fees that pension plans pay for portfolio management against the fees mutual funds pay to "subadvisers" for portfolio management. Such a comparison indicates that mutual funds and pension plans pay like fees for like portfolio management services.

Another way of providing a more accurate comparison is to examine the *total* expenses that pension plans and mutual funds incur to operate, thus incorporating the costs of portfolio management and all other business and administrative expenses. Such a comparison, which is also presented in this article, indicates that public pension plans, on average, have a lower operating expense ratio (i.e., expenses per dollar of assets) but higher expenses per account than mutual funds. Five factors explain this difference:

1. Pension plans manage far fewer accounts than mutual funds;
2. As a result, pension plans have higher average account balances;
3. Mutual funds provide liquidity for their clients and pension plans do not;
4. Pension plans have a greater portion of their assets in fixed-income securities; and
5. Reflecting the choices of pension plan trustees and mutual fund investors, pension plans have a higher proportion of their equity assets in index funds.

Economies of Scale in Mutual Funds and Pension Plans

Mutual funds and pension plans exhibit economies of scale. The operating expenses of individual mutual funds and pension plans, scaled by assets, fall as assets under management rise. As a result, when the assets of pension plans and mutual funds rose in the 1990s, economies of scale put downward pressure on their operating expense ratios.

For mutual funds, the influence of economies of scale was masked by a shift in the preferences of investors toward capital appreciation and international equity funds (both of which are more costly to manage) and by growth in the number of new, smaller funds, which, by virtue of economies of scale, have higher-than-average expense ratios. Adjusting for these factors, the operating expense ratios of mutual funds fell as assets rose from 1990 onward.

The operating expense ratios of mutual funds fall faster than management fees as assets rise. Freeman and Brown claim that this indicates that mutual fund advisers fail to pass on economies of scale in portfolio management. However, roughly the same pattern holds for pension plans. The movement in these two components of overall operating expenses occurs because some of the expenses that mutual funds and pension plans incur are relatively fixed, imparting stronger economies of scale to total operating expenses than to the costs of asset management.

This paper first describes the differences in the organizational structures of mutual funds and public pension plans, and then describes how these organizational differences lead to dissimilarities in their expense structures. The paper next shows that it is inappropriate to compare the fees that pension plans pay for portfolio management with so-called "management fees" of mutual funds because the latter encompass more than the costs of portfolio management. A more appropriate comparison, based on the "subadvisory fees" of

mutual funds, indicates that mutual funds and pension plans incur roughly the same expenses for portfolio management. Thereafter, the paper compares the operating expense ratios and cost per account of pension plans and mutual funds, and also examines economies of scale in the expenses of mutual funds and pension plans. The final section offers conclusions.

ORGANIZATION OF MUTUAL FUNDS AND PENSION PLANS

Mutual funds and pension plans are similar in some respects. Both manage relatively large pools of publicly traded stocks, bonds, and money market instruments. Both pool assets to capture economies of scale and to diversify risks. Both help individuals provide for retirement. Both have oversight boards of directors or trustees that serve as fiduciaries. Nonetheless, mutual funds and pension plans have important differences. This section summarizes the features most relevant to the issues of expenses that are considered in this paper.

Objectives of Mutual Funds and Pension Plans

Mutual funds are sold primarily to individuals, offering them professional investment management, diversification, risk pooling, and liquidity. A fund's objective is to maximize the returns (net of expenses) to the shareholder, given the fund's investment style and level of risk. In essence, mutual funds provide a conduit for passing the rewards and risks of financial market investments to shareholders, either through distributions of income or capital gains. The value of shareholders' claims on a fund fluctuates daily but can nevertheless be readily calculated.

In contrast, pension plans are akin to life insurance products in that both manage asset pools to fund guaranteed payments whose value is uncertain.[6] Pension plans are established by state and local governments (public plans) or businesses (corporate plans) to help employees provide for their retirement. Employers contribute to these plans on behalf of employees. Pension plans receive, pool, and invest these contributions in a manner intended to ensure that plan assets are sufficient to meet current and future obligations to plan participants. The risk of failing to meet those obligations falls on the employer and may even extend to taxpayers.[7]

Although there are many similarities between corporate and public pension plans, in view of the recent interest in comparing the expenses of mutual funds and public pension plans, the remainder of this article focuses mainly on public pension plans.

Clientele of Mutual Funds and Pension Plans

Mutual funds and pension plans, though both help individuals to fund their retirements, serve different clienteles. The clientele of mutual funds in many respects mirrors the population of the U.S. itself. As of 2003, more than 91 million individuals owned shares in mutual funds.[8] According to ICI's *2001 Profile of Mutual Fund Shareholders*, the median investor was in mid-career at age 46, and the median household had roughly $40,000 invested in four mutual funds, or about $10,000 per fund. Only 19 percent of mutual fund investors were retired.[9]

In comparison, pension plans serve far fewer clients (i.e., "participants"), and the average plan participant is older, has been in the work force longer, and has built up larger retirement balances. For instance, in 2001, public pension plans had roughly 23 million participants (both active and retired),[10] with an estimated average age-

[6] Life insurance offers a guaranteed payment for an uncertain date of death. Pension plans promise guaranteed retirement income based on uncertainty about date of death, but also about date of retirement and the employee's salary in his or her final years of employment.

[7] Corporate pension plans are insured against default by the Pension Benefit Guarantee Corporation (PBGC), a federal agency. The PBGC operates by collecting insurance premiums from corporate pension plans. However, if the PBGC's assets were to be exhausted owing to defaults of corporate pension plans, additional outlays might be required by the federal government. The benefits promised by public pension plans are usually backed by the full faith and credit of the sponsoring state or municipality.

[8] Investment Company Institute, "U.S. Household Ownership of Mutual Funds in 2003," *Fundamentals*, Vol. 12, No. 4, October 2003 (www.ici.org/pdf/fm-v12n4.pdf).

[9] The latest year for which this breakdown is available is 2001. See Investment Company Institute, *2001 Profile of Mutual Fund Shareholders* (www.ici.org/pdf/rpt_profile01.pdf).

[10] U.S. Bureau of the Census, 2001 State and Local Government Employee Retirement System survey.

of 51 years, of whom 26 percent were in retirement.[11] Reflecting these and other factors,[12] average assets per participant amounted to about $150,000 in public pension plans.[13]

Regulation of Mutual Funds and Pension Plans

Mutual funds and pension plans both face many legal and regulatory restrictions on their activities. Both have boards of directors or trustees who are responsible for overseeing activities and ensuring compliance with laws and regulations. However, reflecting their dissimilar objectives and clienteles, mutual funds and pension plans operate under different laws and regulations, which can affect their relative expenses.

Mutual funds are regulated by the U.S. Securities and Exchange Commission under the Investment Company Act of 1940 (ICA). Among other things, the ICA includes provisions that: (1) require mutual funds to provide disclosure to investors; (2) provide for the safekeeping of fund assets; (3) restrict unfair or unsound capital structures; (4) prohibit or restrict transactions between a fund and its affiliates; (5) regulate how a fund values its portfolio securities; and (6) require a certain percentage of fund directors to be independent of the fund's adviser and its affiliates.

Public pension plans are governed primarily by the laws and regulations of state and local governments. Because a shortfall in a pension plan's assets (relative to its liabilities) poses a financial risk to the employer and potentially also to taxpayers, most pension plans have legal, regulatory, or board-imposed limits on portfolio composition. For example, many public pension plans are limited as to the proportion of plan assets that can be invested in equities. Portfolios of fixed-income securities are generally less expensive to manage than portfolios of equities, reducing pension plan expenses for portfolio management.

Liquidity

A financial security is a liquid investment if it can be bought or sold quickly with little effect on its price. By law, mutual funds must allow shareholders to redeem their shares on a daily basis at net asset value (NAV). Most mutual funds also continuously offer new shares to investors. These features make mutual funds a highly liquid investment. But liquidity is a costly service. To accommodate the daily ebb and flow of share purchases and redemptions, the fund's portfolio manager must manage the fund's cash and less liquid investments, and the fund must support sophisticated trading systems that allow the portfolio manager to buy and sell securities as needed. Also, most funds have recently made significant investments in computers, human resources, and accounting systems to facilitate the ability of fund investors to purchase or redeem fund share electronically, notably via the Internet.[14]

As a rule, pension plans do not provide participants with liquidity. Plan participants have limited access to their balances before retirement. Consequently, cash flows to and from pension plans are relatively stable, reflecting factors that evolve gradually, such as number of employees, wages and salaries, and benefits payments to current retirees. Evidence that pension plans enjoy an additional degree of comfort in managing assets is that they hold less cash than mutual funds. In 2000, for example, public pension plans held an average of 2.4 percent of assets in liquid investments, compared to 5.6 percent for long-term mutual funds.[15]

[11] These figures are based on the number of active and retired participants in public pension plans that are reported in the *2000 Survey of State and Local Government Employee Retirement Systems,* which is a survey compiled by the Government Finance Officers Association Research Center for the members of the Public Pension Coordinating Council. The survey, though dated 2000, reports data for the fiscal year ended 1998. These data are collated in the so-called *Pendat* database.

[12] Social Security also plays a role. About 30 percent of participants in public pension plans are not covered by Social Security. In such cases, sponsors of public pension plans typically compensate by raising promised benefits and plan contributions. That in turn raises average assets per participant among public plans.

[13] This figure is based on the total of active and retired participants. If retirees were excluded, average assets per participant would be somewhat higher.

[14] See Pozen (2002), pp. 392–418.

[15] The figures for mutual funds are from ICI's *2003 Mutual Fund Fact Book* (www.ici.org/pdf/2003_factbook.pdf). The figures for public pension plans are based on figures from Standard & Poor's MMD Access database.

Investment Management

A mutual fund's investment adviser is responsible for managing the fund's portfolio of securities. Mutual fund investors make broad asset allocations, choosing among bond, equity, hybrid, or money market funds. Still, a fund's investment adviser must make important asset allocation decisions. For example, the adviser of an equity fund must choose how much of the fund's portfolio to hold as cash, and how much to allocate to various sectors like health care, telecommunications, aerospace, and perhaps (especially for hybrid funds) to bonds.[16] Next, the adviser must select individual securities within each asset class ("security selection"). The adviser may make all security selection decisions or may subcontract with an unaffiliated firm (a "subadviser") for security selection.

Pension plans manage their assets to ensure that liabilities to current and future retirees can be met. A "top-down" strategy begins with the pension plan's staff projecting liabilities to current and future retirees.[17] Given projected liabilities, the plan's assets are allocated among broad investments such as equities, bonds, cash, and other investments. This allocation is made by the plan's board with advice from the plan's officers, staff, and outside consultants. It takes account of legal or regulatory restrictions on plan investments, and must balance the expected returns on equities, bonds, and other investments against their associated risks. To achieve the right legal and financial balance, pension plans use consultants and maintain their own staffs of lawyers, actuaries, accountants, financial analysts, and portfolio managers. After asset allocation comes security selection. Pension plan staff sometimes make security selection decisions.

FIGURE 1

Investment Manager Tenure with Public Pension Plans
(years)

	Mandate			
Average of All Mandates	**Domestic Equity**	**International Equity**	**Bond**	**Short-Term**
7.8	7.7	6.8	9.1	12.3

Source: Standard and Poor's MMD Access database

Other times, the plan delegates these decisions to institutional investment managers ("external managers") who manage a specific portion of a plan's assets, such as that allocated to growth stocks. Most plans use a mix of internal and external management, with large plans relying more heavily on internal management, and small plans relying more on external managers.

Pension plans tend to retain external managers for long periods, with the average tenure being about eight years (Figure 1). In part, this is because the search for a new external manager can be costly. The search must ensure that the external manager's style meets the pension plan's goals, that the external manager has no conflicts of interest, and that the external manager's fees are reasonable. In addition, the fund may incur "transition costs," which can arise from the need to sell some assets and purchase others in order to match the investment style of the newly hired external manager.[18] Cost is not the only reason why external managers tend to have relatively long tenures, though. Pension plans endeavor to establish strong bonds of trust with their external managers. Hence, a plan is unlikely to dismiss an external manager whose performance falls below expectations for a period if the pension plan has otherwise had a long, successful relationship with that manager.

THE STRUCTURE OF MUTUAL FUND AND PENSION PLAN EXPENSES

Mutual funds and pension plans use similar-sounding terms to refer to dissimilar expense concepts. An appreciation of these terms and the expense reporting conventions followed by mutual funds and pension plans is crucial to understanding and analyzing differences in their expenses.

[16] See, for example, Pozen (2002), pp. 208–221.

[17] This projection entails studying demographics, such as employee pay scales, likely ages of employee retirement and death, and the retirement benefits promised by the plan sponsor.

[18] A recent study by Frank Russell (2001) estimates that transitions between external managers could cost a pension plan 100 to 200 basis points of the assets transferred.

Mutual Fund Expenses

Virtually all mutual funds are externally managed. Services are provided by separate legal entities, such as the fund's investment adviser, an affiliate of the adviser, or an independent third party. These services include portfolio management (provided by the fund's adviser or a subadviser), administrative and business services (typically provided by the fund's adviser or a related party), and shareholder services (provided by the transfer agent). The fees for these services plus other fees that are paid for directly by the fund, when divided by the fund's average net assets, make up the fund's "operating expense ratio."[19]

Management Fee. The fund's investment adviser typically receives a single fee from the fund called a "management fee." This fee compensates the adviser for asset allocation and security selection, managing the fund's assets in accordance with its prospectus, and making securities trades. The management fee typically also covers the costs of administrative and business services that the fund must have to operate. These include fund and portfolio accounting, valuation of portfolio securities, oversight of the fund's transfer agent and custodian, legal analysis to ensure compliance with federal and state laws and regulations, preparation and filing of regulatory and tax reports, and preparation and distribution of prospectuses and shareholder reports. The management fee also compensates the adviser for its expenses related to the salaries of fund officers and the costs of clerical staff, office space, equipment, and certain accounting and recordkeeping facilities. Finally, the management fee must offer the fund's adviser a competitive rate of return on capital.

Because a fund's management fee includes business and administrative costs, as well as expenses arising from portfolio management, it cannot be used to approximate costs incurred for portfolio management. Indeed, both the SEC (2000) and Freeman and Brown noted the difficulty in trying to use a fund's management fee as a proxy for portfolio management costs.[20,21]

Transfer Agent Fee. Transfer agents keep shareholder records, process transactions, and maintain costly customer service departments and call centers. Most mutual funds pay a separate fee to their transfer agents for these kinds of services. Commonly, the transfer agent bills the fund for services at a fixed, annual fee per account, which runs about $20 to $30 per year.[22] However, for some mutual funds, transfer agent fees are encompassed in an all-inclusive or "unified" management fee. For these kinds of funds, the management fee is an even more inaccurate measure of the costs that the fund incurs for portfolio management.

"Other Fees." Mutual funds incur a number of ancillary expenses, such as custodial, legal, audit, registration, and directors' fees.[23] Because these kinds of fees tend to be relatively fixed, they typically contribute significantly more to the operating expense ratio of a small fund than to that of a large fund.[24] This is important because it indicates that small funds may benefit more than large funds from asset growth.

[19] This definition excludes distribution fees charged under what are known as 12b-1 plans.

[20] In *Report on Mutual Fund Fees and Expenses,* December 2000, footnote 60 (www.sec.gov/news/studies/feestudy.htm), the SEC's Division of Investment Management noted the difficulty of interpreting the management fees of mutual funds as a proxy for the fund adviser's costs of portfolio management services:

> Some funds define the term management fee narrowly, to cover only the cost of selecting portfolio securities. These funds pay for administration, record keeping, and other services under separate contracts with other service providers. Other funds define the management fee broadly, to cover a variety of administrative and other services, in addition to expenses associated with selecting portfolio securities. A few funds have "unified" fees under which the management fee pays for all fund expenses (the management fee is equal to the expense ratio). Thus, if Fund A has a higher management fee than Fund B, it may mean that Fund A pays a higher fee to its adviser. Alternatively, it may mean that Fund A's management fee pays for services that are provided and charged for separately by Fund B's adviser, an affiliate of the adviser, or outside contractors.

[21] Freeman and Brown acknowledge that the advisory fees paid by public pensions and the management fees of mutual funds can be difficult to compare. They note that "the 'management fee' reported in Morningstar sometimes includes not only fees for advisory services but some administrative services as well."

[22] See *Mutual Fund Transfer Agents: Trends and Billing Practices 1999,* Investment Company Institute.

[23] Some researchers, including Freeman and Brown, use the term "administrative fees" to refer to the sum of transfer agent fees and "other fees." This is not generally how mutual funds define administrative fees or costs, and it is not in keeping with the definition used in the legally mandated reports that funds must file semiannually with the SEC (the so-called N-SAR reports).

[24] For example, suppose an audit costs $50,000. That would add 100 basis points to the expense ratio of a $5 million fund, but only 50 basis points if the fund's assets grew to $10 million, a drop of 50 basis points. For a larger fund, similar growth in assets would have less effect on the fund's expense ratio. For example, while a $50,000 audit would add 10 basis points to the expense ratio of a $50 million fund, it would add 9.1 basis points to the expense ratio of a $55 million fund, a drop of less than 1 basis point.

Pension Plan Expenses

The two primary categories of expenses for pension plans are portfolio management fees and administrative fees. The sum of these two kinds of expenses, when divided by plan assets, is termed the plan's "operating expense ratio" in this article. These two types of expenses differ in concept from the similarly named counterparts of mutual funds.

Portfolio Management Fees ("Advisory Fees"). Most pension plans manage a portion of their assets internally and allocate the remainder to an external manager. When used, an external manager is responsible for portfolio management (securities selection, executing trades, and limited reporting) within a given sector, such as small-cap stocks. For these services, the pension plan pays the external manager a fee, which plans variously call "investment advisory fees," "investment management fees," or just "management fees."[25] However, in contrast to the "management fees" incurred by mutual funds, the fees paid by pension plans to external managers are narrow in scope. They do not cover the costs of business and administrative activities that pension plans must have to operate. These instead are comprised in the "administrative fees" of pension plans.

Administrative Fees. Administrative fees include the salaries of the pension plan's board, officers, and staff, whose duties include asset allocation, satisfying portfolio limits set by law or the board, ensuring compliance with other laws and regulations, accounting and auditing, managing relationships with external managers, disbursing benefits payments to beneficiaries, and collecting contributions from employers. Administrative fees also include expenses related to managing assets not allocated to external managers, including salaries and benefits of portfolio managers who are members of the pension plan's staff. In addition, administrative costs cover rent to house pension plan staff and operations, computer costs, and expenses (such as fees paid to consultants) for monitoring and hiring and firing of external managers.

In short, the fees paid by public pension plans to external managers comprise only the costs of portfolio management. In comparison, the "management fees" reported by mutual funds are broad in scope, encompassing the costs of portfolio management, as well as a range of business and administrative services. Freeman and Brown attempted to show that mutual funds overpay for portfolio management services by comparing the fees paid by public pensions to external managers with the management fees of mutual funds. Given that the management fees of mutual funds cover a broader array of services, it is not surprising that Freeman and Brown found that the management fees of mutual funds exceed the fees paid by public pensions to external managers. However, this says little about the relative portfolio management expenses.

It is possible to compare the expenses of mutual funds and pension plans in other, more appropriate ways. One approach is to compare the fees paid by pension plans to external managers with a similar measure for mutual funds. The next section does that by examining fees paid by mutual funds to subadvisers. An alternative approach is to compare the total operating expenses of mutual funds and pension plans. That approach is taken up in a subsequent section.

PORTFOLIO MANAGEMENT EXPENSES OF PENSION PLANS AND SUBADVISED MUTUAL FUNDS

The advisers of some mutual funds contract with unaffiliated third-party investment managers for management of all or a portion of their funds' portfolios. The third-party manager, called a "subadviser," holds a position equivalent to that of an external investment manager to a pension plan. Like the pension plan's external manager, the mutual fund's subadviser provides portfolio management services, which primarily entail security selection, trading, and reporting services. The subadviser receives a fee for these services ("subadvisory fee") that the fund's adviser pays for out of the management fee, which it receives from the fund. Funds that are subadvised report

[25] To limit confusion, to distinguish these fees from the management fees of mutual funds, and to maintain consistency with Freeman and Brown, the remainder of the paper will call the fees paid by public pension plans to external managers "advisory fees." However, in contrast with Freeman and Brown, this article does not re-label the management fees of mutual funds as "advisory fees." Such a re-labelling invites the reader to mistakenly infer that the management fees of mutual funds are comparable to the advisory fees that pension plans pay to external managers.

FIGURE 2

Fee Schedules of Institutional Money Managers for Managing Investment Portfolios
(basis points for millions of dollars under management)

	Median Fee for Separately Managed Institutional Accounts				
Investment Objective	**$10 million**	**$50 million**	**$100 million**	**$250 million**	**$500 million**
Equity					
Large-Cap	68	54	45	39	36
Small-Cap	95	81	75	67	65
Mid-Cap	75	68	61	54	52
Value	70	55	47	40	38
Growth	75	60	52	45	41
Fixed-Income					
Long-Term	35	30	26	22	19
Intermediate-Term	38	30	26	22	21
High-Yield	50	50	47	38	35
Short-Maturity	28	25	22	18	16

Source: Frank Russell/Mellon Analytical Services, August 2001

both their management fees and the portion paid to the subadviser. As a result, it is possible to compare the portfolio management fees incurred by pension plans with a comparable measure by examining the subadvisory fees of mutual funds.

Institutional money managers sometimes serve both as subadvisers to mutual funds and as external advisers to pension plans. When they do, fee negotiation typically begins from a common fee schedule, like that which money managers charge for portfolio management of institutional accounts (Figure 2). Fee rates typically fall as the size of the portfolio increases, are higher for equity than for fixed-income portfolios, and among equity portfolios are highest for small-cap portfolios. In addition, fee schedules are fairly "flat" in that a large percentage increase in assets leads to a relatively modest basis point reduction in fee rates. For example, for a large-cap equity portfolio, a fifty-fold increase in assets from $10 million to $500 million leads to a reduction in the fee rate by less than half, from 68 basis points to 36 basis points.

Because fee negotiations often begin from a common fee schedule, it seems plausible to expect that the subadvisory fees of mutual funds should be similar to the fees that pension plans pay to external managers for portfolio management. Evidence indicates that that is the case (Figure 3). For small- and medium-sized portfolios, mutual fund subadvisory fees are lower than those that Freeman and Brown report as being paid by public pension plans. For large-sized portfolios, the fees reportedly paid by public pension plans are slightly lower. Overall, however, the fees are similar, averaging 28 basis points for public pension plans and 31 basis points for subadvised mutual funds.

In sum, this evidence suggests that mutual funds and pension plans incur like fees for like portfolio management services. The conclusion reached by Freeman and Brown that mutual funds overpay for portfolio management is based on a comparison of fees for unlike services.

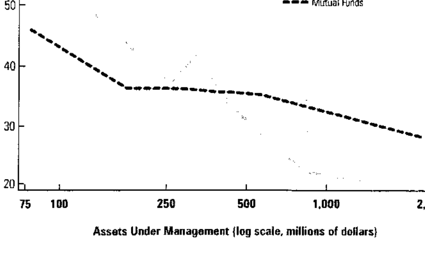
UNDERSTANDING DIFFERENCES IN THE OPERATING EXPENSES OF MUTUAL FUNDS AND PENSION PLANS

Although mutual funds and pension plans are fundamentally different investment vehicles, comparisons have nevertheless been made between their operating expense ratios. For instance, studies have compared the operating expenses of the two vehicles in the U.S. to help foreign countries structure their retirement systems.[26] In order to achieve a degree of comparability,

[26] See, for example, the World Bank study by James, Smalhout, and Vittas (2001).

FIGURE 3

Fees Paid by Public Pension Plans to External Managers for Portfolio Management and Subadvisory Fees of Mutual Funds
(fees paid for active management of domestic equity portfolios)



Sources: Freeman and Brown (2001) for external management fees, Lipper Associates, Inc. (2000) and Strategic Insight Mutual Fund Research and Consulting, LLC (2000) for subadvisory fees of mutual funds

this section compares the operating expense ratios of pension plans to the operating expense ratios of mutual fund complexes, measured as a weighted average of the operating expense ratios of all funds in a particular complex.[27,28]

In 1998, the average operating expense ratio of mutual fund complexes was 71 basis points, compared to 31 basis points for public pension plans (Figure 5). However, it would be incorrect to conclude that public pension plans are more efficient than mutual funds because efficiency can also be measured in terms of cost per account. From this standpoint, mutual funds are highly efficient, incurring average expenses of $148 per account, compared to $335 for public pension plans (Figure 6).

The striking difference between the expenses of mutual fund complexes and pension plans measured relative to assets, or relative to number of accounts, is the topic of this section. Analysis indicates that it reflects the dissimilar structures of mutual funds and pension plans, and that their dissimilarities are adequately explained by a handful of factors.

Understanding the Operating Expense Ratios of Pension Plans and Mutual Funds

Five main factors account for the difference in the operating expense ratios of mutual fund complexes and pension plans: number of accounts managed; average size of accounts managed; portfolio composition; indexation; and liquidity provision.

Number of Accounts. Mutual funds and pension plans face economies of scale in accounts managed. Generally speaking, as the number of accounts managed rises, average expenses per account falls. The average mutual fund complex manages vastly more accounts than the average public pension plan (Figure 4, line 1). This gives mutual funds a sizable cost advantage in terms of expenses per account relative to pension plans.

[27] A mutual fund complex is the collection of individual funds all managed by a single investment adviser.

[28] Throughout this section, mutual fund expenses exclude 12b-1 fees and are measured at the complex level. 12b-1 fees are excluded because they support distribution, and thus are unrelated to the ongoing costs of operating a mutual fund. In addition, exclusion of 12b-1 fees aids the comparison with pension plans; pension plans, which essentially have captive clienteles, do not pay for distribution. Mutual fund expenses are measured at the complex level to improve the comparison with pension plan expenses. Pension plans invest in fixed equities, fixed-income securities, liquid assets, and other assets. Because fixed-income securities and cash are typically less costly to manage than are equities, it would be inappropriate to compare the expenses of pension plans with those of equity mutual funds alone or with fixed-income mutual funds alone. One way to achieve a level of comparability is to examine the expenses of mutual fund *complexes*, because a given mutual fund complex is much more likely to manage both equity and fixed-income products. Finally, because pension plans are long-term savings vehicles, we exclude from the analysis the assets held in money market mutual funds. For another study that examines the expense ratios of mutual fund complexes, see Baumol et al. (1990).

FIGURE 4

Characteristics of Mutual Fund Complexes[1] and Public Pension Plans, 1998

	Mutual Fund Complexes	Public Pension Plans[2]
1. Average Number of Accounts (asset-weighted)	8,887,178	402,235
Memo: Simple Average	428,464	84,454
2. Average Account Balance (dollars)[3]	$29,667	$143,682
3. Assets in Equities (percent of total assets)	71%	61%
Memo: Assets in Fixed-Income Securities (percent of total assets)	20%	36%
4. Percent of Equity Assets in Index Funds	9%	47%
5. Redemption Rate (annual average)	34%	3%

[1] Excludes the money market funds of mutual fund complexes.

[2] Excludes $770 million in assets of public pension plans whose expenses are subsidized by employers.

[3] For mutual funds, average account balance is measured as fund total net assets divided by number of accounts; for public pensions, it is measured as pension fund assets divided by number of participants plus current beneficiaries.

Sources: Pendat for public pension funds, Lipper Associates, Inc. and Investment Company Institute for mutual funds

Account Balances. Other things the same, a mutual fund or pension plan with a high average account balance will have a lower operating expense ratio than one with a lower average balance.[29] Mutual funds have considerably lower average account balances than pension plans (Figure 4, line 2). This helps to explain why mutual fund complexes have higher operating expense ratios but lower expenses per account than public pension plans. Mutual funds are very efficient in terms of cost per account, but they manage vastly more accounts with lower average balances than pension plans. Thus, by simple arithmetic, mutual funds tend to have higher total expenses per dollar of assets than do public pension plans.[30]

Portfolio Composition. Equity pools are more costly to manage than pools of fixed-income securities. Thus, an institution with a higher-than-average proportion of its assets in equities will have higher-than-average portfolio management expenses, boosting its operating expense ratio. Pension plans shifted away from fixed-income securities toward equities during the 1990s. Nevertheless, by the end of the decade, pension plans still had a smaller proportion of their assets in equities than did long-term mutual funds (Figure 4, line 3). This held down the operating expense ratios of public pension plans relative to mutual funds.

Indexation. Indexed portfolios can be managed inexpensively because they entail little or no research costs. Pension plan trustees have favored indexed investments more than have mutual fund investors. At year-end 1998, public pension plans had an estimated 47 percent of their equity investments in index funds, whereas just 9 percent of equity mutual fund assets were in index funds (Figure 4, line 4).

Liquidity. Direct estimates of the costs of providing liquidity are unavailable. However, they can be gauged indirectly by comparing the operating expense ratios of mutual funds and pension plans with their corresponding redemption rates (measured as total dollar redemptions plus exchanges divided by assets). Average redemption rates of mutual funds are considerably higher than like measures for public pension plans (Figure 4, line 5).[31]

[29] This is because certain kinds of expenses rise with the number of individuals served rather than with assets under management. For example, consider two mutual funds, both with $1 billion in assets under management. Assume that the first fund has 50,000 accounts, giving it an average account balance of $20,000. Assume, also, that the second fund has 100,000 accounts for an average account balance of $10,000. Suppose, reasonably, that the transfer agents of both funds bill their respective funds for services provided at a flat rate of $25 per account. In that case, transfer agent fees contribute 12.5 basis points to the expense ratio of the first fund and 25 basis points to the expense ratio of the second fund.

[30] James, Smalhout, and Vittas (2001) make essentially the same point, noting that "holding aggregate assets constant, the expense ratio [of a mutual fund] increases with the number of shareholders and decreases as average account size rises. The basic reason ... is that funds incur a fixed cost per account for record-keeping and shareholder communication ... and the larger each account the smaller this cost will be, as a percentage of assets." Baumol et al. (1990) also make this point, indicating that "an increase in assets per account leads to a decrease in costs. The reason for this is that an increase in assets per account with a fixed total quantity of assets must entail a decrease in the number of accounts, an occurrence that can be expected to reduce total costs."

[31] The influence of liquidity on the relative expenses of mutual funds and pension plans was mentioned over a decade ago by Baumol et al (1990) in a comment about the so-called Wharton Report (1962), prepared for Congress by the Wharton School of Finance and Commerce at the University of Pennsylvania. Baumol et al. note that "The Wharton Report ... compared the advisory fees charged to mutual funds versus other [institutional] clients. [However, Baumol et al. noted that] such fee comparisons are clouded by the fact that the same bundle of services is not offered. For example, one important difference is the ability of mutual fund shareholders to engage in virtually unlimited transactions. While this would lead to higher costs, the fee comparisons [in the Wharton Report] made no adjusrments for this important factor."

Combined Effects. Together, these five factors largely explain the differences in the operating expense ratios and cost per account between mutual funds and public pension plans. For example, analysis in the appendix indicates that a mutual fund complex with attributes identical to those of the average public pension plan (the attributes shown in the right-most column of Figure 4) would have an operating expense ratio of about 35 basis points, little different from the *actual* average of 31 basis points for a public pension plan.[32]

ECONOMIES OF SCALE IN MUTUAL FUNDS AND PENSION PLANS

By definition, economies of scale exist if the average costs of production decline with increases in the scale of output, holding product mix constant.[33] For instance, in the auto industry, the average cost of producing an automobile declined with mass production. Studies of financial intermediaries—bank, thrifts, credit unions, insurance companies, as well as mutual funds and pension plans—have most often taken "output" to mean assets under management. In that case, economies of scale arise if the average cost of managing a dollar of assets declines as assets rise.

Economies of Scale in the Operating Expenses of Mutual Funds and Pension Plans

Research has found that mutual funds and pension plans, like other financial intermediaries, exhibit economies of scale in assets under management.[34] For example, Figure 5 compares the operating expense ratios of mutual fund complexes and pension plans by assets under management.[35] Over the range of assets, operating expenses fall by 109 basis points for mutual funds and 94 basis points for public pension plans, indicating economies of scale in assets under management.

Research has also shown that economies of scale tend to dissipate quickly as the assets of financial intermediaries expand. For example, the operating expense ratio for public pension plans falls 65 basis points as assets rise from $25 million to $250 million, but only 30 basis points as assets rise from $250 million to $65 billion. The reason for the greater economies of scale evident among smaller institutions is simple: Fixed costs matter more for small than for large institutions. This is important because it indicates that the influence of economies of scale on a fund's expense ratio is not limitless, contrary to opinions sometimes expressed.[36] Indeed, because economies of scale dissipate as a firm's assets expand, asset growth may reduce the expense ratios of already large funds relatively little.[37]

The presence of economies of scale requires careful interpretation. For pension plans and mutual funds, as for other financial intermediaries, the concept of an "output" is ambiguous. An "output" can also be viewed in terms of number of accounts managed,[38] in which case economies of scale arise if average expenses per account

[32] Another factor that could explain some of the differences in operating expense ratios of mutual funds and pension plans is that the reported expenses of public pension plans may be understated. Hsin and Mitchell (1997) indicate that "[p]rivate pension systems are likely to report most administrative expenditures, including operating expenses and such expenses as building and capital depreciation, but these may not be properly accounted for by public pension plan administrations. Public plans might also understate their costs if they share equipment or offices with other government branches. Hence, administrative expenses reported by public pension agencies almost certainly understate the full cost of resources devoted to providing pension services, a point that should be kept in mind when comparing the administrative efficiency of public and private pension systems." This same situation likely applies to a comparison of the operating expense ratios of public pension plans with those of mutual funds.

[33] See Carlton and Perloff (2000), p. 36.

[34] For evidence on banks, see Wheelock and Wilson (2001) and references therein. Mitchell (1981) and Hsin and Mitchell (1997) present evidence for private and public defined benefit pension plans, respectively. For mutual funds, see Baumol et al. (1990), Collins and Mack (1997), Latzko (1999), and LaPlante (2001). For evidence on life insurance companies, see Yuengert (1993). Finally, for evidence on thrifts, see Mester (1993).

[35] For mutual funds, economies of scale may arise at the share class level (Latzko (1999)), the fund level, or the complex level (Baumol et al. (1990); Collins and Mack (1997)), or all three. To maintain comparability with public pension plans, however, the analysis here is conducted at the complex level.

[36] For example, Freeman and Brown state that "[g]iven the [mutual fund] industry's explosive growth, one would expect that [mutual] fund expenses on average would have plummeted." It is telling that researchers have not advanced this argument with respect to the expenses of banks, insurance companies, pension plans, or other financial intermediaries, even though they too face economies of scale and have experienced robust asset growth in the past few decades.

[37] Researchers have often noted that the benefits of economies of scale are not limitless for financial intermediaries. For example, James, Smalhout, and Vittas (2001) suggest that "economies from asset aggregation [by mutual funds] do not continue indefinitely."

[38] For a comparison of economies of scale in mutual funds by assets under management and by number of accounts, see Baumol et al (1990). For a similar study with respect to public pension plans, see Hsin and Mitchell (1997).

FIGURE 5

Economies of Scale in Operating Expense Ratios of Public Pension Plans and Mutual Fund Complexes, 1998
(asset-weighted, basis points)

	Public Pension Plans		Mutual Fund Complexes[1]	
Decile	Assets Under Management (millions of dollars)	Operating Expense Ratio (basis points)	Assets Under Management (millions of dollars)	Operating Expense Ratio (basis points)
1	24	120	8	176
2	97	111	33	135
3	246	55	96	116
4	535	63	171	129
5	1,040	53	347	117
6	1,967	50	711	111
7	5,011	30	1,687	101
8	9,628	46	3,367	99
9	20,507	36	10,300	85
10	64,377	26	88,400	67
Average	**10,249**	**31**	**10,388**	**71**

[1] Excludes money market funds. Also excluded are complexes that are primarily institutional (either as reported by the complex itself, or as indicated by an average account balance in excess of $500,000, or as indicated by complexes with fewer than 100 accounts).

Sources: Pendat for public pension plans, Lipper Associates, Inc. and Investment Company Institute for mutual funds

FIGURE 6

Economies of Scale in Expenses per Account of Public Pension Plans and Mutual Fund Complexes, 1998
(account-weighted, basis points)

	Public Pension Plans		Mutual Fund Complexes[1]	
Decile	Number of Participants	Expenses per Participant (dollars)	Number of Accounts	Expenses per Account (dollars)
1	180	1,844	330	1,023
2	857	692	1,002	704
3	1,890	582	2,780	731
4	4,053	928	5,167	424
5	7,978	726	10,518	524
6	17,876	413	23,053	376
7	53,305	323	47,675	438
8	94,385	412	107,074	295
9	182,339	467	377,839	198
10	481,688	254	4,028,925	132
Average	**84,454**	**335**	**428,464**	**148**

[1] Excludes money market funds. Also excluded are complexes that are primarily institutional (either as reported by the complex itself, or as indicated by an average account balance in excess of $500,000, or as indicated by complexes with fewer than 100 accounts).

Sources: Pendat for public pension plans, Lipper Associates, Inc. and Investment Company Institute for mutual funds

FIGURE 7

Assets of Long-Term Mutual Funds and Public Defined Benefit Pension Plans in Selected Investment Objectives, Selected Years

	1992	1994	1996	1998	2000
Long-Term Mutual Funds[1]					
Percent of Long-Term Assets in:					
Fixed-Income (Bond Funds)	46	34	25	20	16
Hybrid	7	11	10	9	7
Equity	47	55	66	71	77
Memo: Percent of Equity Assets in:					
Growth and Income Funds	45	39	38	40	32
Capital Appreciation Funds	46	42	45	47	54
International Funds	9	19	17	13	14
Public Defined Benefit Pension Plans					
Percent of Assets in:					
Fixed-Income	45	44	34	31	
Other	11	12	9	10	
Equity	45	45	57	60	
Memo: Percent of Equity Assets in:					
Domestic Securities	95	88	79	79	
International Securities	5	12	21	21	

[1] *Excludes money market mutual funds.*
Sources: Investment Company Institute for long-term mutual funds and Pendat for public pension plans

fall as the number of accounts rises. Figure 6 compares the cost per account of mutual funds and pension plans. As before, pension plans and mutual funds exhibit economies of scale: Average cost per account falls as output (number of accounts) rises. Once again, small institutions benefit most from economies of scale, in that cost per account declines fastest for smaller institutions as the number of accounts managed rises.

The presence of economies of scale requires careful interpretation for another reason. Economies of scale are a property of individual firms, rather than of an industry *per se.* Thus, if mutual funds have economies of scale in asset management, the operating expense ratio of a particular fund is expected to fall as its assets under management rise. This does not mean, however, that the average expense ratio of all mutual funds must fall as industry assets rise. As the industry expands, product mix could change, contrary to the definition of economies of scale. Alternatively, industry assets could increase because of a large number of new, small mutual funds, which, reflecting economies of scale, have higher-than-average expense ratios.

Both of these factors were at work in the 1990s. Scale economies were masked by a shift in the mix of the assets of mutual funds and pension plans from bonds toward equities (Figure 7), and, within equities, toward international equities. This likely raised the expenses incurred by pension plans and mutual funds because equities are more costly to manage than bonds,[39] and international equities are generally more costly to manage than domestic equities. In addition, mutual funds experienced a shift in assets away from growth and income funds toward capital appreciation funds, the latter of which are more costly to manage.

[39] See, for example, Figure 2.

FIGURE 8

Number of Equity Mutual Funds Created, 1990–2002

Year Created	Number of Funds Created	Average Net Assets of Funds as of 2002[1] (millions of dollars)	Percent of All Equity Funds in Existence as of 2002[1]
1990 or before	1,009	1,949	19.3
1991	135	801	2.6
1992	228	711	4.4
1993	276	480	5.3
1994	365	350	7.0
1995	309	345	5.9
1996	335	295	6.4
1997	466	182	8.9
1998	458	161	8.8
1999	488	120	9.3
2000	555	70	10.6
2001	418	55	8.0
2002	181	44	3.5

[1] *Measured as of December 2002.*
Source: Investment Company Institute

Also, in the 1990s many new equity funds were created. New funds tend to be sma'! and take many years to grow to the size of pre-existing funds. For example, Figure 8 shows the number of new equity funds created in recent years. Equity funds created after 1990 account for 80 percent of all equity funds in existence as of December 2002. However, by 2002, these new funds were still considerably smaller in size than funds created in 1990 or before. For example, funds created in 1990 or before had average net assets of about $1.9 billion in December 2002, while those created in 1995 had grown to have assets of only $345 million. These kinds of developments obscure the influence of economies of scale in industry-average expense ratios. Suppose, for instance, that the expense ratios of funds that existed in 1990 or before fell from 1991 to 2002 as their assets grew. Nevertheless, the average expense ratio of *all* funds might fall little because new funds, which will tend to have higher expense ratios, boost the industry average.[40]

To properly assess the influence of economies of scale, the effects of changes in product mix and newly created funds must be disentangled. Studies that adjust for changes in the product mix of mutual funds, or that track individual mutual funds through time, have generally concluded that economies of scale have worked to lower fund expense ratios.[41] To illustrate, Figure 9 tracks the operating expense ratios of share classes of long-term mutual funds continuously in existence from 1990 to 2002. This eliminates the effects of newly created mutual funds. In addition, to reduce the influence of changes in product mix, the figure examines expense ratios for a range of investment objectives. From 1990 to 2000, most of these investment objectives saw healthy asset growth, and among those that did, average operating expense ratios declined on net. Since 2000, in large measure because of the correction in the equity market, the assets of the equity mutual funds included in Figure 9 have fallen, and, owing to economies of scale, the operating expense ratios of equity fund objectives have risen since then.[42]

What Is the Source of Economies of Scale for Mutual Funds and Pension Plans?

The economies of scale evident in the operating expense ratios of mutual funds and pension plans could reflect economies from portfolio management, from other components of operating expenses, or from both.

[40] Costs are also influenced by factors other than assets, such as the level and quality of services provided. The development of the Internet has allowed financial intermediaries to offer customers better access to information and to transact more easily, but it has also required significant capital investment on the part of both mutual funds and defined benefit pension plans.

[41] See, for example, Lipper Analytical (1997), Rea, Reid, and Millar (1999), General Accounting Office (2000), and LaPlante (2001).

[42] The rise in the average expense ratio of these funds since 2000 owes almost entirely to the influence of transfer agent fees and "other fees" such as audit, registration, custody, and directors' fees. Because the dollar amounts of these fees either depend on the number of accounts managed (transfer agent fees) or are relatively fixed ("other fees"), when assets fell at these equity funds after 2000, these fees by sheer arithmetic added more to the expense ratios of equity funds. In contrast, the basis point contribution of management fees to the operating expense ratios of these equity funds was essentially unchanged as assets fell after 2000. Thus, advisers of these funds have not generally raised management fees in the past few years.

FIGURE 9

Operating Expense Ratios for Long-Term Mutual Funds, Selected Investment Objectives, 1990–2002

(share classes continuously in existence since 1990)

Equity Mutual Funds

(basis points)

	Capital Appreciation			International			Total Return			Hybrid		
	Assets	Average Expense Ratio		Assets	Average Expense Ratio		Assets	Average Expense Ratio		Assets	Average Expense Ratio	
	(billions of dollars)	Asset-Weighted	Simple Average	(billions of dollars)	Asset-Weighted	Simple Average	(billions of dollars)	Asset-Weighted	Simple Average	(billions of dollars)	Asset-Weighted	Simple Average
1990	83	96	130	21	95	146	92	66	94	17	72	97
1991	97	96	128	23	99	152	103	64	93	21	68	97
1992	139	95	122	28	102	152	130	62	91	34	67	95
1993	186	95	117	35	101	141	173	61	87	56	65	91
1994	228	95	114	63	97	129	208	63	88	79	67	89
1995	281	93	113	77	94	129	246	62	88	87	65	90
1996	395	89	108	96	90	125	328	59	86	98	61	88
1997	500	81	106	124	87	123	443	55	83	115	57	87
1998	620	78	104	140	85	120	576	53	81	136	54	84
1999	750	76	103	145	82	126	666	50	81	146	53	84
2000	1,057	77	102	184	79	119	643	50	83	132	54	[illegible]
2001	801	80	105	147	80	127	589	51	85	132	54	86
2002	640	84	108	125	82	138	514	52	88	132	54	91

Bond Mutual Funds

(basis points)

	Corporate and High-Yield			Government and Mortgage-Backed			Global			Municipal		
	Assets	Average Expense Ratio		Assets	Average Expense Ratio		Assets	Average Expense Ratio		Assets	Average Expense Ratio	
	(billions of dollars)	Asset-Weighted	Simple Average	(billions of dollars)	Asset-Weighted	Simple Average	(billions of dollars)	Asset-Weighted	Simple Average	(billions of dollars)	Asset-Weighted	Simple Average
1990	39	76	85	82	64	71	1	119	119	96	58	63
1991	38	74	85	84	63	70	2	117	115	110	58	62
1992	52	71	82	100	61	70	3	106	109	135	57	63
1993	71	67	81	116	60	69	6	95	99	166	56	63
1994	82	66	80	109	61	70	11	92	93	186	54	63
1995	80	67	80	91	62	71	12	94	95	176	56	65
1996	90	66	80	85	63	72	14	89	93	179	56	65
1997	104	64	80	78	62	71	15	86	94	178	55	65
1998	117	61	77	75	62	71	14	88	98	185	55	65
1999	124	60	76	77	60	69	10	94	106	196	53	63
2000	116	59	77	70	58	71	7	91	146	174	52	64
2001	123	57	78	77	57	70	7	96	117	181	51	63
2002	132	56	80	94	55	68	6	95	97	186	52	64

Sources: Lipper Associates, Inc. and Investment Company Institute

FIGURE 10

Operating Expense Ratios of Mutual Funds and Pension Plans, 1998

Mutual Funds

Decile	Assets (millions of dollars)	Operating Expense Ratio (basis points)	Management Fees (basis points)	Difference (basis points)
1	15	154	90	64
2	30	133	72	61
3	65	136	84	52
4	127	118	79	39
5	218	121	84	37
6	425	96	66	30
7	1,012	100	72	27
8	2,415	97	64	33
9	7,372	97	71	26
10	65,853	59	40	20

Sources: Lipper Associates, Inc. and Investment Company Institute

Public Pension Plans

Decile	Assets (millions of dollars)	Operating Expense Ratio (basis points)	Fees Paid to External Managers ("Advisory Fees") (basis points)	Difference (basis points)
1	59	67	45	22
2	161	62	43	19
3	378	51	35	16
4	779	58	41	17
5	1,258	56	40	16
6	2,732	43	33	10
7	6,237	31	21	9
8	11,489	28	17	11
9	29,037	37	31	6
10	86,811	22	14	8

Source: Pendat

Corporate Pension Plans

Decile	Assets (millions of dollars)	Operating Expense Ratio (basis points)	Fees Paid to External Managers ("Advisory Fees") (basis points)	Difference (basis points)
1	22	96	44	52
2	28	96	45	51
3	35	88	41	47
4	44	89	40	49
5	58	78	40	38
6	77	75	38	37
7	106	72	39	33
8	168	63	36	27
9	302	61	35	26
10	4,555	48	27	21

Source: Department of Labor, Form 5500

Hypothetical Mutual Fund or Pension Plan

Assets (millions of dollars)	Operating Expense Ratio (basis points)	Portfolio Management Fees (basis points)	Difference (basis points)
10	118	68	50
50	64	54	10
100	50	45	5
250	41	39	2
500	37	36	1

It is sometimes suggested that economies of scale should be greater for portfolio management than for other factors.[43] However, evidence for mutual funds has been interpreted as suggesting the opposite. For example, Freeman and Brown show that the operating expense ratios of domestic equity mutual funds fall faster than their management fees as assets expand. This indicates that mutual funds exhibit weaker economies of scale in management fees than in the other components of operating expenses, namely transfer agent fees and "other fees." Freeman and Brown *assume* that economies of scale ought to be at least as great in management fees, and, based on this assumption, conclude that fund advisers are not fully passing along economies of scale in fund management fees to shareholders.

However, an alternative, more plausible, explanation is available. Figure 10 shows the operating expense ratios of mutual funds, their management fees, and the difference between the two. As Freeman and Brown noted, operating expense ratios are seen to fall faster than management fees as assets rise. However, Figure 10 shows that public and corporate pension plans exhibit much the same trait. For instance, the operating expense ratios of public pension plans decline more sharply than fees paid to external managers ("advisory fees") as assets rise.

This likely occurs because the management fees of mutual funds and the advisory fees of pension plans are asset-based, while the other expenses they incur have a significant fixed component. A simple example illustrates. Suppose that a mutual fund or a pension plan incurs only two costs: audit fees and fees for portfolio management. Assume that annual audit fees total $50,000. In addition, suppose that the mutual fund or pension plan incurs portfolio management fees identical to those in Figure 2 for large-cap equities. For this hypothetical mutual fund or pension plan, operating expenses decline more rapidly than portfolio management fees as assets increase (Figure 10, bottom panel). This happens because, as suggested earlier, fixed costs can impart significant economies of scale to a small mutual fund or pension plan, but relatively weaker economies of scale to a large mutual fund or pension plan.

In short, the operating expense ratios of mutual funds fall faster than their management fees as assets increase for the same reason that the operating expense ratios of pension plans fall faster than their advisory fees: Institutional investors—whether they are mutual funds, pension plans, or other entities—pay fees for portfolio management that are primarily asset-based while their remaining operating costs have a significant fixed component.

CONCLUSION

Although mutual funds and pension plans have some features in common—such as managing large pools of assets—they also have significant organizational and institutional differences. Because of these differences, considerable care must be exercised when analyzing the expenses of the two entities. When care is exercised, seemingly apparent differences in the expenses of mutual funds and pension plans fade. For example, there is little evidence that mutual funds overpay for the services they receive. On the contrary, the evidence presented in this article indicates that mutual funds and pension plans pay like fees for like portfolio management services. Moreover, this article shows that mutual funds are highly cost effective in terms of cost per account to individual shareholders. In addition, careful analysis indicates, as expected, that economies of scale help to reduce the expense ratios of mutual funds as assets increase. Finally, there is no compelling evidence that mutual fund advisers fail to pass on economies of scale in portfolio management.

APPENDIX: A STATISTICAL ANALYSIS OF THE OPERATING EXPENSES OF MUTUAL FUND COMPLEXES

The text relies on the statistical analysis described in this appendix. The analysis uses a linear regression approach to examine the operating expense ratios of the long-term (bond, equity, and hybrid) assets of mutual fund complexes. Mutual fund complexes are used, rather than individual mutual funds themselves, in order to keep the analysis simple, and to maintain as great a degree of comparability as possible with the structure of pension plans.

[43] For example, the SEC (2000) indicates that "most observers believe that portfolio management is the fund cost with the greatest economies of scale."

FIGURE A1

Statistical Analysis of Operating Expense Ratios of Mutual Fund Complexes

Dependent Variable: Operating Expense Ratio for Mutual Fund Complex; Long-Term Assets Only

Variable	Coef. Estimate	"T-Statistic"
1. log(number of accounts)	-8.09	-14.12
2. log(average account balance)	-14.25	-6.96
3. % of complex assets in equity funds	.28	4.42
4. % of complex equity fund assets in index funds	-.34	-2.93
5. log(complex average redemption rate)	4.97	2.98
6. constant	205.75	15.09
7. R-squared	.54	
8. Number of observations	256	

The regression model posits that the operating expense ratio (the total expense ratio net of 12b-1 fees) depends on: (1) the percent of complex assets in equity funds; (2) the percent of complex equity fund assets that are in index funds; (3) the average redemption rate (measured as redemptions plus redemption exchanges divided by assets) for a complex; (4) total number of accounts for the complex; and (5) the average account balance for the complex. Thus, the regression model is:[44]

operating expense ratio = $\beta_0 + \beta_1$ *log(number of accounts)* + β_2 *log(average account balance)* + β_3 *(% of complex assets in equity funds)* + β_4 *(% of complex equity fund assets in index funds)* + β_5 *log(complex average redemption rate)*

The most recent data we had for public pension plans was as of 1998. Consequently, the regression analysis also uses data for mutual fund complexes as of 1998. In order to ensure that the complexes represent retail, as opposed to institutional investors, complexes with over 50 percent of their assets in institutional accounts have been eliminated, as well as those complexes with average account balances of over $500,000 or with fewer than 100 accounts. The excluded complexes have a relatively small proportion of the total long-term assets of mutual funds, amounting to about $100 billion as of December 1998.

The results of the regression analysis (Figure A1) indicate that the operating expense ratios of mutual fund complexes exhibit economies of scale in both number of accounts and average account balance (the coefficient estimates in lines 1 and 2 are both negative). However, as Hsin and Mitchell (1997) found for public pension plans, economies of scale tend to be greater in average account balance than in number of accounts (the coefficient estimate in line 1 is smaller in absolute terms than the coefficient in line 2). This indicates that for a given number of accounts, a fund complex with a higher-than-average account balance will have a lower-than-average operating expense ratio. This helps explain why institutional mutual funds, as well as public pension plans, tend to have lower operating expense ratios than retail mutual funds. The regression analysis also indicates that funds with a high proportion of complex assets in equity funds will have a commensurately higher operating expense ratio, acknowledging the fact that equity mutual funds tend to be more expensive to manage than bond or hybrid mutual funds. The analysis also suggests that the average operating expense ratio for a complex will be lower, the greater the proportion of its equity assets that are in index funds (the coefficient in line 4 is negative). Finally, complexes with higher-than-average redemption rates will have higher-than-average operating expense ratios (line 5), indicating that it is costly to provide liquidity. The R-squared of .54 indicates that the model fits the data rather well.

The analysis in the text uses the regression coefficients in Figure A1, along with the characteristics shown in Figure 4, to derive an expected average operating expense ratio of 36 basis points for a mutual fund complex with attributes similar to those of the average public pension plan.

[44] A similar framework is used by Hsin and Mitchell (1997) to analyze the operating expense ratios of public pension plans.

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APPENDIX 2

DIVISION OF
INVESTMENT MANAGEMENT

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

July 8, 2003

The Honorable Paul E. Kanjorski
Ranking Member
Subcommittee on Capital Markets, Insurance,
and Government Sponsored Enterprises
U.S. House of Representatives
Washington, DC 20515

Dear Congressman Kanjorski:

Thank you for your June 30, 2003 letter concerning my testimony at the June 18, 2003 hearing of the House Financial Services Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises on HR 2420, the Mutual Funds Integrity and Fee Transparency Act of 2003.

In your letter, you raised a number of questions regarding the testimony presented at the hearing. Set forth below are the staff's responses to those questions. The staff diligently has endeavored to answer these questions as completely as possible; however, there may be a few instances, as noted, where we have incomplete information.

The questions presented in your letter are set forth below in bold italics, followed by our responses. Please note that the views expressed in the responses are those of the staff and may not necessarily reflect the views of the Commission. I hope that the responses are helpful to you. As with all issues involving the protection of investors, I welcome the opportunity to share our views on these matters. If you have additional questions or comments, please do not hesitate to contact me at 202/942-0720.

Sincerely,

Paul F. Roye
Director
Division of Investment Management

Enclosure

cc: Chairman Richard H. Baker
Chairman
Subcommittee on Capital Markets, Insurance,
and Government Sponsored Enterprises

Please briefly describe the number and type of rules adopted by the Securities and Exchange Commission since 1998 concerning investment companies and their advisers, as well as the rulemaking proposals currently pending.

The Commission has adopted 40 rules that apply to investment companies and investment advisers since January 1, 1998. Nine rule proposals are currently pending. A breakdown of these rules by category is as follows:

	Rule Categories	*Number of Rules*
I.	**Rules Adopted Pursuant to Specific Statutes**	**10**
	A. Sarbanes-Oxley Act	6
	B. USA PATRIOT Act	1
	C. Electronic Signatures in Global and National Commerce Act	2
	D. Gramm-Leach-Bliley Act	1
II.	**Other Adopted Rules**	**30**
	A. Streamlining Investment Company Disclosure	5
	B. Investment Company Disclosure Requirements	4
	C. Disclosure Requirements Affecting All Types of Issuers, Including Investment Companies	4
	D. Investment Adviser Disclosure Requirements	2
	E. Exemptive Rules	7
	F. Other Rules Alleviating Regulatory Restrictions	3
	G. Operating Rules	5
III.	**Pending Rule Proposals**	**9**
	A. Investment Company Disclosure Requirements	2
	B. Disclosure Requirements Affecting All Types of Issuers, Including Investment Companies	1
	C. Investment Adviser Disclosure Requirements	1
	D. Exemptive Rules	1
	E. Operating Rules	3
	F. Other	1

A complete list of these rules is in Appendix I.

APPENDIX I

I. Rules Adopted Pursuant to Specific Statutes

A. **Sarbanes-Oxley Act**

Chief Executive and Financial Officer Certifications of Exchange Act Periodic Reports under Sections 302 and 906 (2002/2003)*

Improper Influence on Conduct of Audits (2003)

Standards Relating to Listed Company Audit Committees (2003)

Implementation of Standards of Professional Conduct for Attorneys (2003)

Auditor Independence (2003)

Code of Ethics and Audit Committee Financial Expert Disclosure (2003)

B. **USA PATRIOT Act**

Customer Identification Programs for Mutual Funds (2003)

C. **Electronic Signatures in Global and National Commerce Act**

Electronic Recordkeeping by Investment Companies and Investment Advisers (2001)

Exemption from consumer consent requirements of the Electronic Signatures in Global and National Commerce Act (2000)

D. **Gramm-Leach-Bliley Act**

Privacy of Consumer Financial Information (Regulation S-P) (2000)

II. Other Adopted Rules

A. **Streamlining Investment Company Disclosure**

Amendment of Fee Table for Variable Annuity Contracts (2002)

Adoption of Dedicated Registration Form for Variable Life Insurance (2002)

Delivery of Disclosure Documents to Households (1999)

Amendments to Registration Form for Mutual Funds (1998)

* Year of adoption or proposal is in parentheses.

Mutual Fund Profile (1998)

B. Investment Company Disclosure Requirements

Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies (2003)

Disclosure of Mutual Fund After-Tax Returns (2001)

Disclosure Regarding Independent Directors of Investment Companies (2001)

Investment Company Names (2001)

C. Disclosure Requirements Affecting All Types of Issuers, Including Investment Companies

Requirements for Arthur Andersen LLP Auditing Clients (2002)

Auditor Independence Requirements (2000)

Audit Committee Disclosure (1999)

Plain English Disclosure (1999)

D. Investment Adviser Disclosure Requirements

Proxy Voting by Investment Advisers (2003)

Electronic Filing by Investment Advisers, Amendments to Form ADV (2000)

E. Exemptive Rules

Transactions of Investment Companies With Portfolio and Subadviser Affiliates (2003)

Investment Company Mergers (2002)

Acquisition of Securities During the Existence of an Underwriting or Selling Syndicate (2002)

Role of Independent Directors of Investment Companies (2001)

Offer and Sale of Securities to Canadian Tax-Deferred Retirement Savings Accounts (2000)

Exemption to Permit Certain Investment Advisers to Temporarily Advise Investment Companies without Shareholder Approval (1999)

Exemption To Allow Investment Advisers To Charge Fees Based Upon a Share of Capital Gains Upon or Capital Appreciation of a Client's Account (1998)

F. Other Rules Alleviating Regulatory Restrictions

Custody of Investment Company Assets with a Securities Depository (2003)

Foreign Custody of Investment Company Assets (2000)

Repurchase Agreements and Refunded Securities (2001)

G. Operating Rules

Registration Requirements for Certain Investment Advisers Operating Through the Internet (2002)

Personal Investment Activities of Investment Company Personnel (1999)

Deregistration of Certain Registered Investment Companies (1999)

Registration Requirements for Investment Advisers Operating in Multiple States (1998)

Investment Adviser Year 2000 Reports (1998)

III. Pending Rule Proposals

A. Investment Company Disclosure Requirements

Shareholder Reports and Quarterly Portfolio Disclosure of Registered Management Investment Companies (2002)

Amendments to Investment Company Advertising Rules (2002)

B. Disclosure Requirements Affecting All Types of Issuers, Including Investment Companies

Disclosure of Issuer Stock Repurchases (2002)

C. Investment Adviser Disclosure Requirements

Electronic Filing by Investment Advisers, Amendments to Form ADV Part 2 (Firm Brochure) (2000)

D. Exemptive Rules

Certain Broker-Dealers Deemed Not to be Investment Advisers (1999)

E. Operating Rules

Compliance Programs of Investment Companies and Investment Advisers (2003)

Custody of Funds or Securities of Clients by Investment Advisers (2002)

Political Contributions by Certain Investment Advisers (1999)

F. Other

Amendments to Safe Harbor from Liability for Manipulation of Issuer Repurchases of Common Stock (2002)

PREPARED STATEMENT OF JOHN C. BOGLE*

FOUNDER AND FORMER CHIEF EXECUTIVE OF THE VANGUARD GROUP
PRESIDENT OF THE BOGLE FINANCIAL MARKETS RESEARCH CENTER

FEBRUARY 26, 2004

Good morning, Chairman Shelby and Members of the Committee. Thank you for inviting me to speak today.

I hope that my experience in the mutual fund industry will be helpful in considering the issues before you. I have been both a student of, and an active participant in, the mutual fund industry for more than half a century. My interest began with an article in the December 1949 issue of *Fortune* magazine ("Big Money in Boston") that inspired me to write my Princeton University senior thesis ("The Economic Role of the Investment Company") on this subject. Upon graduation in 1951, I joined Wellington Management Company, one of the industry pioneers, and served as its Chief Executive from 1967 through January 1974. In September 1974, I founded the Vanguard Group of Investment Companies, heading the organization until February 1996, and remaining as Senior Chairman and Director until January 2000. Since then I have served as President of Vanguard's Bogle Financial Markets Research Center. The views I express today do not necessarily represent those of Vanguard's present management.

The recent market timing scandals that have thrust the mutual fund industry into the limelight have illustrated, in a most shocking way, this industry's profile. But these scandals are but the tip of the iceberg. For they have also illuminated the fact that too far, too great an extent, this industry has focused on the financial interests of its managers at the cost of the 95 million citizens who have entrusted their hard-earned assets to us. While the damage done to our shareholders by allowing selected investors to do market timing at the expense of their fellow fund shareholders has been estimated at some $5 billion, excessive management fees and fund expenses can easily be siphoning off many times that amount, year after year. And our focus on marketing speculative funds that pander to the public tastes probably cost the investing public hundreds of billions of dollars in the recent market crash.

As discouraging as the scandals are to someone like me, who has dedicated his life to the mutual fund industry, they also have a good side, in that they bring to light all of the nibbling around the edges of ethical behavior that has been happening for decades. In that respect, the scandals present us a wonderful opportunity to finally get it right, and I hope that, with the help of Congress and our regulators, we seize that opportunity. Toward that end, it is high time that we carefully examine how the fund industry works today, and the extent to which it is serving the national public interest and the interest of investors. The preamble to the Investment Company Act of 1940 demands that funds be "organized, operated, and managed" in the interests of their shareholders rather than in the interests of their "investment advisers and underwriters." But that sound principle has, I fear, been turned upside down.

Let me begin with the conclusion I reached in my thesis, all those years ago. My extensive study of the industry led me to four conclusions: One, that mutual funds should be managed "in the most efficient, honest, and economical way possible," and that fund sales charges and management should be reduced. Two, mutual funds should not lead the public to the "expectation of miracles from management," since funds could "make no claim to superiority over the (unmanaged) market averages." Three, that "the principal function (of funds) is the management of their investment portfolios"—the trusteeship of investor assets—focusing "on the performance of the corporation . . . (not on) the short-term public appraisal of the value of a share (of stock)." And four, that "the prime responsibility" of funds "must be to their shareholders," to serve the individual investor and the institutional investor alike.

In retrospect, the industry described in my thesis is barely recognizable today. Not just in size, for, as I predicted, an era of growth lay ahead for this industry, although I don't think anyone could have anticipated that mutual funds would grow from $2 billion in assets then to over $7 *trillion* today. If my thesis described a *tiny* industry, I'm not sure what adjective would be adequate to describe today's giant.

But the real difference between funds *past* and funds *present,* the principal theme of my statement, is not that dramatic change in size, but the change in the very character of the industry. A half-century ago, the mutual fund industry was one in which the idea was to sell what we made: Funds provided a prudently diversified list of investments, and offered the small investor peace of mind. It was an industry

*NOTE: Much of the material in this statement was included in a presentation before the Boston Society of Security Analysts on January 14, 2003.

that focused primarily on stewardship. By contrast, the industry we see today is one focused primarily on salesmanship, an industry in which marketing calls the tune in which we make what will sell, and in which short-term performance is the name of the game.

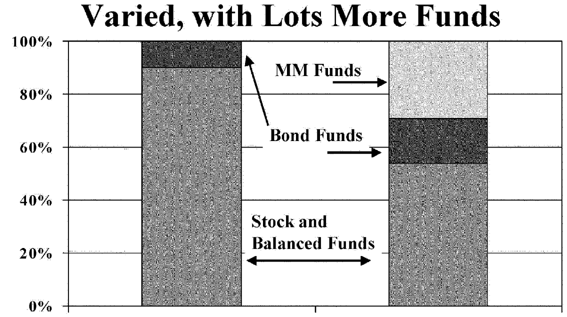
This change in character is not an illusion. Since I entered this industry slightly over a half-century ago, there are specific, quantifiable ways in which this industry has changed. Today, I will examine nine of them, and then conclude with an appraisal their impact on the effectiveness with which mutual funds serve their shareholders, and some suggestions on returning this industry to its roots. I will be using industry averages to measure these changes. Of course some fund firms—not nearly enough in my view—have strived to retain their original character. But be clear that the mutual fund industry has changed radically. Let me count the ways:

1. Funds are Far Bigger, More Varied, and More Numerous

The mutual fund industry has become a giant. From its 1949 base of $2 *billion,* fund assets soared to $7.2 *trillion* at the outset of 2004, a compound growth rate of 16 percent. Then, 90 percent of industry assets were represented by stock funds and stock-oriented balanced funds. Today, such funds compose just over half of industry assets (54 percent). Bond funds now represent 17 percent of assets, and money market funds—dating back only to 1970—constitute the remaining 29 percent. Once an equity fund industry, we now span the universe of major financial instruments—stocks, bonds, and savings reserves—a change that has been a boon not only to fund investors, but also to fund managers as well.

So too has the number of funds exploded. Those 137 mutual funds of yesteryear have soared to today's total of 8,200. More relevantly, the total number of common stock funds has risen from just 75 to 4,600.[1] The investor today has more mutual funds to choose among than common stocks listed on the New York Stock Exchange (2,800). It is not clear, however, that the nature of this increase has created investor benefits, for in retrospect, "choice" has done more harm than good.

1. The Industry: Bigger and More Varied, with Lots More Funds



	1949	2003
Total Net Assets	$2.2b	$7,200b
# of Funds	137	8,200
# of Stock Funds	75	4,600

2. Stock Funds: From the Middle-of-the-Road to the Four Corners of the Earth

As the number of stock funds soared, so did the variety of objectives and policies they follow. In 1950, the stock fund sector was dominated by funds that invested largely in highly diversified portfolios of U.S. corporations with large market capitalizations, with volatility roughly commensurate that of the Standard & Poor's 500 Stock Index. And today such middle-of-the-road funds represent a distinct minority of the total. While 2,524 of the 3,599 equity funds measured by Morningstar are

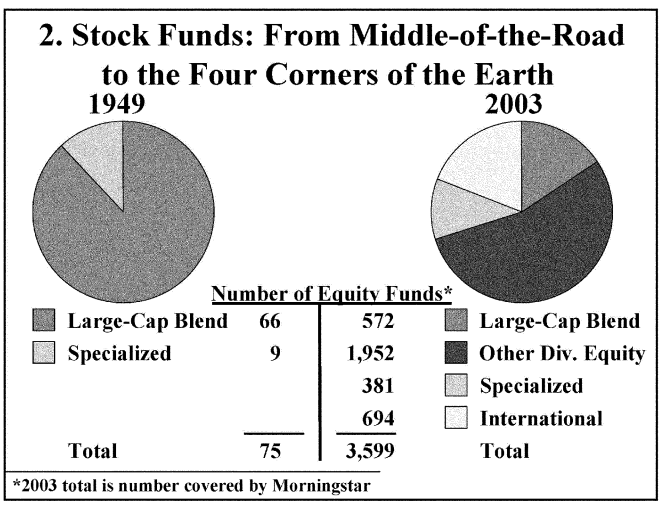
[1] Sixty-six of these original diversified funds, constituting 90 percent of equity fund assets, were broadly diversified "blue chip" funds. The remaining nine funds (10 percent of assets) were largely "single industry" funds that were soon to vanish.

considered diversified U.S. stock funds, only 572 funds now closely resemble their blue-chip ancestors.[2]

In addition to the diversified U.S. funds, there are 381 specialized funds focused on narrow industry segments, from technology to telecommunications (particular favorites during the late bubble), and 694 international funds, running the gamut from diversified funds owning shares of companies all over the globe to highly specialized funds focusing on particular Nations, from China to Russia to Israel. We offer a fund for every purpose under heaven.

Paradoxically, the major new entrant in the stock fund derby since 1950—the stock market index fund—represents a throwback to a simpler age. The first index fund was created in 1975. It holds the 500 stocks in the S&P 500 Index and seeks to match its return (before costs). With its first cousin, the total stock market index fund (owning essentially all publicly held U.S. stocks), introduced in 1987, these consummate middle-of-the-road funds now account for 8 percent of equity fund assets. On the other hand, there are also market segment index funds (matching, for example, a technology stock index or an index of Austrian stocks), the antithesis of their diversified forebears.

In substance, a half-century ago investors could have thrown a dart at a list of stock funds and had *nine chances out of ten* to pick a fund whose return was apt to closely parallel that of the market averages. Today, they have just *one chance out of eight!* The 1949 *Fortune* article noted the allegation that Massachusetts Investors Trust (M.I.T.), the first and then-largest mutual fund, did no more than give investors "a piece of the Dow Jones Average." But the author was right when he presciently added, "the average is not a bad thing to own." In any event, selecting mutual funds has, for better or worse, become an art form.



3. From Investment Committee to Broadway Stardom

These vast changes in fund objectives have led to equally vast changes in how mutual funds are managed. In 1950, the major funds were managed almost entirely by *investment committees,* and that original *Fortune* article pictured the M.I.T. trustees and their advisory board as they made their investment decisions. There they are—not quite as dour as the famous Grant Wood portrait of the Iowa couple in "American Gothic," but pretty close—distinguished of mien, serious of visage, doleful of countenance. The picture almost shrieks: *We are conservative!*

But the demonstrated wisdom of the collective was soon overwhelmed by the perceived brilliance of the individual. The "Go-Go" era of the mid-1960's introduced both the concept of far more aggressive "performance funds" and the notion of a

[2] The accepted terminology in equity funds reflects this change. We have come to accept a nine-box matrix of funds arranged by *market capitalization* (large, medium, or small) on one axis, and by *investment style* (growth, value, or a blend of the two) on the other. Yesteryear's middle-of-the-road funds would today find themselves in the "large-cap blend" box, constituting just 23 percent of the funds in the diversified U.S. fund category, and 14 percent of the Morningstar all-equity fund total.

"portfolio manager." That era had much in common with the recent bubble, as fund sponsors introduced hot funds with supercharged returns (often based on cooked-up numbers), aggressively marketed through stock brokerages. The new game seemed to call for free-wheeling individual talent, and the portfolio manager gradually became the prevailing standard. Today, the term "investment committee" has vanished, apparently replaced by "management team." But "portfolio manager" is the advisory model for some 3,400 funds of the 4,094 stock funds listed in Morningstar.

The coming of the age of portfolio managers who serve as long as they produce performance moved fund management from the stodgy old consensus-oriented investment committee to a more entrepreneurial, free-form, and far less risk-averse approach. Before long, moreover, the managers with the hottest short-term records had been transformed by their employers' vigorous public relations efforts, and the enthusiastic cooperation of the media, into "stars," and a full-fledged star-system gradually came to pass. A few portfolio managers actually *were* stars—Fidelity's Peter Lynch, Vanguard's John Neff, Legg Mason's Bill Miller, for example—but most proved to be *comets,* illuminating the fund firmament for a moment in time and then flaming out, their ashes floating gently down to earth. Even after the devastation of the recent bear market, and the stunning fact that the tenure of the average portfolio manager is just 5 years, the system remains largely intact.

4. Turnover Goes Through the Roof

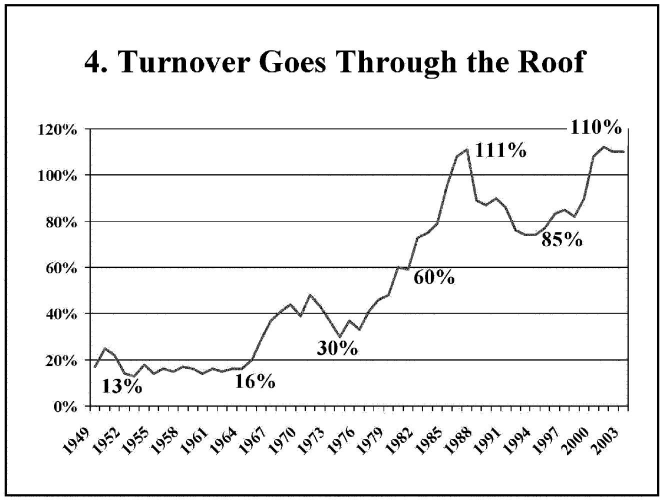
Together, the coming of more aggressive funds, the burgeoning emphasis on short-term performance, and the move from investment committees to portfolio managers had a profound impact on mutual fund investment strategies—most obviously in soaring portfolio turnover. At M.I.T. and the other funds described in that *Fortune* article, they didn't even *talk* about long-term investing. They just *did* it, simply because that is what trusteeship is all about. But over the next half-century that basic tenet was turned on its head, and short-term speculation became the order of the day.

Not that the long-term focus didn't resist change. Indeed, between 1950 and 1965, it was a rare year when fund portfolio turnover much exceeded 16 percent, meaning that the average fund held its average stock for an average of about 6 years. In the Go-Go era, that figure nearly *tripled,* to 48 percent (a 2-year holding period), only to fall back to an average of 37 percent (a 3-year holding period) after the 1973–1974 market crash. But that was just the beginning.

With the elimination of fixed commissions on stocks in 1975 and the later burgeoning of electronic trading networks, the unit costs of buying and selling plunged. Turnover rose accordingly, averaging about 80 percent from the early 1980's through 1999. And it has risen even further since then, with fund managers turning their portfolios over at an astonishing average annual rate of 110 percent(!). Result: Compared to that earlier 6-year standard that prevailed for so long, the average stock is now held for just 11 months.

The contrast is stunning. At 16 percent turnover, a $1 billion fund sells $160 million of stocks in a given year and then reinvests the $160 million in other stocks, $320 million in all. At 110 percent, a $1 billion fund sells and then buys a total of $2.2 billion of stocks each year—nearly seven *times* as much. Even with lower *unit* transaction costs, it's hard to imagine that such turnover levels aren't a major drain on shareholder assets.

When I say that this industry has moved from investment to speculation, I do not use the word speculation lightly. Indeed, in my thesis I used Lord Keynes' terminology, contrasting *speculation* (forecasting the psychology of the market) with *enterprise* (forecasting the prospective yield of an asset). I concluded that as funds grew they would move away from speculation and toward enterprise (which I called "investment"), focusing, not on the price of the share but on the value of the corporation. As a result, I concluded, fund managers would supply the stock market "with a demand for securities that is *steady, sophisticated, enlightened,* and *analytic.*" I was dead wrong. Mutual fund managers are no longer stock *owners.* They are stock *traders,* as far away as we can possibly be from investing for investment icon Warren Buffett's favorite holding period: *Forever.*



5. High Stock Turnover Leads to Low Corporate Responsibility

Whatever the consequences of this high portfolio turnover are for the shareholders of the funds, it has had dire consequences for the governance of our Nation's corporations. In 1949, *Fortune* wrote, "one of the pet ideas (of M.I.T.'s Chairman Merrill Griswold) is that the mutual fund is the ideal champion of . . . the small stockholder in conversations with corporate management, needling corporations on dividend policies, blocking mergers, and pitching in on proxy fights." And in my ancient thesis that examined the economic role of mutual funds, I devoted a full chapter to their role "as an influence on corporate management." Mr. Griswold was not alone in his activism, and I noted with approval the SEC's 1940 call on mutual funds to serve as "the useful role of representatives of the great number of inarticulate and ineffective individual investors in corporations in which funds are interested." By appraising corporate management critically and expertly, the SEC added, funds can "not only serve their own interests, but also the interests of other public stockholders."

It was not to be. Just as my early hope that funds would continue to invest for the long-term went aborning, so did my hope that funds would observe their responsibilities of corporate citizenship. Of course, the two are hardly unrelated: A fund that acts as a trader, focusing on the price of a share and holding a stock for but 11 months, may not even own the shares when the time comes to vote them at the corporation's next annual meeting. By contrast, a fund that acts as an owner, focusing on the long-term value of the enterprise, has little choice but to regard the governance of the corporation as of surpassing importance.

A half-century ago, funds owned but 2 percent of the shares of all U.S. corporations. Today, funds own some 23 percent of all stocks. They could wield a potent "big stick," but with few exceptions, they have failed to do so. As a result of their long passivity and lassitude on corporate governance issues, fund managers bear no small share of the responsibility for the failures in corporate governance and accounting oversight that were among the major forces creating the recent stock market bubble and the bear market that followed. It is hard to see anything but good arising when this industry at last returns to its roots and assumes its responsibilities of corporate citizenship.

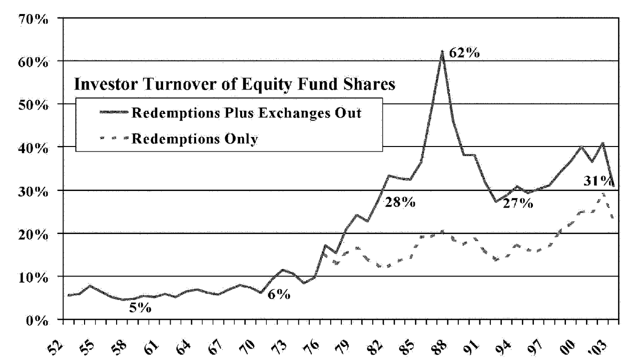
6. The Fund Shareholders Get the (Wrong) Idea

The change in this industry's character has radically affected the behavior of the mutual fund shareholder. In the industry described in the *Fortune* article as having "tastes in common stocks that run to the seasoned issues of blue-chip corporations," shareholders bought fund shares and held them. In the 1950's, and for a dozen years thereafter, fund redemptions (liquidations of fund shares) averaged 6 percent of assets annually, suggesting that the average fund investor held his or her shares for 16 years. Like the managers of the funds they held, fund owners were investing for the long pull.

But as the industry brought out funds that were more and more performance-oriented, often speculative, specialized, and concentrated—funds that behaved increasingly like individual stocks—it attracted more and more investors for whom the long-term didn't seem to be relevant. Indeed, in the 1970's the industry added a not-so-subtle temptation to investors to trade among funds, an "exchange privilege" that facilitated swaps between funds in a given family. Up, up, up went the redemption rate, actually reaching 62 percent in the year of the 1987 market crash. Last year, the redemption rate (including exchanges *out* of funds) totaled 31 percent, an average holding period of slightly more than 3 years. The time horizon for the typical fund investors had tumbled by fully 80 percent .

This change in behavior has forced a change in the delivery mechanism for fund shares. As "buy and hold" turned to "pick and choose," the average fund owner who once held a single equity fund came to hold four. *Freedom of choice* became the industry watchword, and "fund supermarkets," with their "open architecture," made it easy to quickly move money around in no-load funds. Trading costs are hidden in the form of access fees for the shelf-space offered by these supermarkets, paid for by the funds themselves, so that swapping funds seemed to be "free," tacitly encouraging fund shareholders to trade from one to another. But while picking tomorrow's winners based on yesterday's performance is theoretically attractive, in practice it is a strategy that is doomed to failure.

6. Fund Shareholders Get the (Wrong) Idea



*2003 figure is through November, annualized

7. The Modern Mutual Funds . . . Made to be Sold

It is easy to lay the responsibility for this astonishing telescoping of holding periods on gullible, flighty, and emotional fund investors, or on the change in the character of our financial markets. After all, the investment climate was relatively peaceful during the 1950's and early 1960's, while the boom and bust in the stock market bubble of 1997–2002 was clearly a mania driven by the madness of crowds.

But the fund industry was a major contributor to that bubble. Departing from our time-honored tenet, "we sell what we make," we jumped on the "we make what will sell" bandwagon, creating new funds to match the market mania of the moment. First, it was during the Go-Go era when "concept stocks" were the rage, and at least one-half of the new funds we formed were "performance funds," sold not on the soundness of their policies and strategies, but on the glitter of their often illusory and sometimes fraudulent records. Then, during the recent market bubble, when technology and telecom stocks led the way, we formed 494 new technology, telecom, and Internet funds, and aggressive growth funds favoring these sectors. It was not just the industry opportunists who sought to capitalize on this foolishness. As the prices of "new economy" stocks moved relentlessly upward, many of the most respected firms in the industry—to their later embarrassment—abandoned their investment discipline, formed speculative funds, and offered them to their clients.

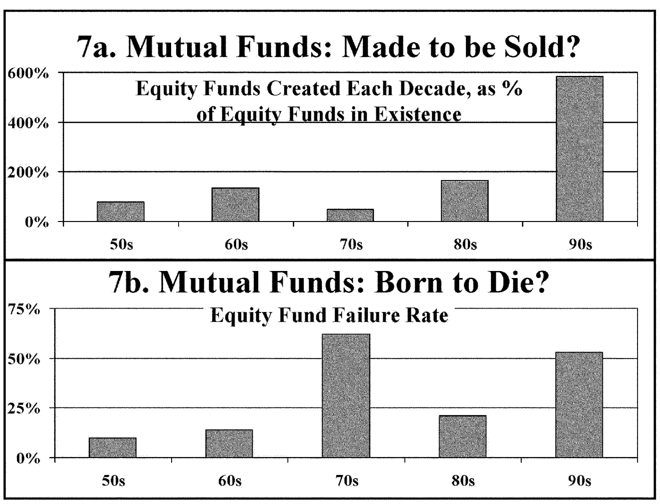
But in the recent mania it was considerably easier to bring the investor sheep into the new-fund fold. Why? Because funds were now permitted to advertise their returns, and advertise them they did. Consider just one issue of a single magazine:

In the March 2000 issue of *Money,* right at the market peak, 44 mutual funds advertised their performance. *Their average return over the previous 12 exuberant months came to +85.6 percent!* Small wonder that this industry took in $555 billion of new money—more than a *half-trillion dollars*—during 1998–2000, overwhelmingly invested in the new breed of speculative high-performance funds.

And just as those winners of yesteryear led the market upward and attracted all that money, so they led the market on the way down and saw it vanish. In 1998–1999, the hottest 10 funds provided a cumulative average return of 332 percent, only to decline by 75 percent in 2000–2002. While the resultant net gain of 8 percent for the shareholder of the fund throughout the period, the overwhelming majority came in late, garnering little if any of the upside, and most, if not all, of the downside. The industry's cash flow, of course, traced the same up-then-down pattern. Eternally a trailing indicator in this ever-market-sensitive business, the gushing equity cash flow of the boom actually turned negative in the bust—an $18 billion *outflow* as the market reached its low in 2002. Today, it is not *irrational exuberance* but *rational disenchantment* that permeates the community of fund owners.

In another astonishing reversal, this flagrant formation of new funds soon began to unwind. Fund deaths began to match, and will surely soon exceed, fund births. But it is not the old middle-of-the-road funds that are dying; it is largely the new breed of funds—those that sought out the exciting stocks of the new economy and hyped their records. Most of those stodgy funds of 1950 remain survivors. M.I.T. and the other 10 largest funds of a half-century ago ($75 million or more in assets!) remain in business today.

Those early funds were, as the saying goes, "built to last." Typically, 99 percent of the funds in business at the beginning of each year were still around at its end, and nearly 90 percent still in business after a decade, with some 10 percent liquidating or merging with another fund. But as "built to last" turned to "born to die" during the Go-Go era, that decade-long failure rate then rose to 60 percent in the 1970's, only to fall back to 18 percent in the 1980's. Then, in the 1990's, the failure rate soared to 50 percent. The acceleration continued in 2000–2002, with nearly 900 funds giving up the ghost—an annual failure rate averaging 7 percent. If that rate continues (and there is reason to believe it may accelerate), half of today's funds won't be around a decade hence.



8. The Costs of Fund Ownership

When "Big Money in Boston" featured Massachusetts Investors Trust, it was not only the oldest and largest mutual fund, but also the least costly. The *Fortune* article reported that its annual management and operating expenses, paid at the rate of just 3.20 percent of its investment income, amounted to just $827,000. In 1951, its "expense ratio" (expenses as a percentage of fund assets) was just 0.29 percent, the lowest in the industry, and the average expense ratio for the 25 largest funds, with aggregate assets of but $2.2 billion, was only 0.64 percent.

What a difference five decades makes! In 2002, M.I.T.'s expense ratio had risen to 1.20 percent, and its $126 million of expenses consumed 80 percent(!) of its investment income. The average expense ratio for the equity funds managed by the 25 largest fund complexes has risen 139 percent to 1.53 percent despite the fact that assets have soared 1,070-fold, to nearly $2.4 *trillion.* The dollar amount of direct fund expenses borne by shareholders of *all* equity funds has risen from an estimated $15 *million* in 1950 to something like $35 *billion* in 2003. There are staggering economies of scale in mutual fund management, but it is obvious that fund investors have not only not shared in these economies, but have also been victims of far higher costs.

Of course, the expense ratio is only part of the cost of fund ownership. And in those olden days, the industry's no-load (no sales commission) segment represented less than 3 percent of industry assets. The predominant form of distribution was the independent broker-dealer, and the fund buyer typically paid a sales charge averaging perhaps 6 percent on each purchase. Spread over a then-holding period of perhaps 15 years, that additional cost of about 0.4 percent per year brought the all-in direct costs of fund ownership to, say, 1.00 percent annually.

The distribution mechanism has changed. Now, no-load funds are a powerful force in the industry, accounting for some 40 percent of equity fund assets. And for load funds, the traditional front-end sales charge has been largely supplanted by a host of "alphabet" shares, usually with no front-end commission. Rather, the sales charge is paid in annual installments of 1 percent a year or so, usually aggregating about 6 percent. When this "distribution fee" is included in the fund's expense ratio, there are significant conceptual differences in comparing today's fund expense ratios with those of a half-century earlier.

The fund industry reports that the costs of fund ownership have steadily declined, but it is difficult to take that allegation seriously when total fund operating expenses have, as stated earlier, risen more than 3,000-fold(!) since 1950. While the *ratio* of fund expenses to fund assets *may* be lower, such a decline arises only because investors are increasingly choosing no-load funds and low-cost funds, *not* because of substantial management fee reductions. Stripped of statistical legerdemain, recent industry data show that direct all-in equity fund expenses amount to 1.46 percent of *assets,* not far from the crude unweighted 1.66 percent expense ratio reported for the average equity *fund.*

The industry data on what it calls "the cost of mutual fund ownership" is shockingly understated. Why? *Because it omits one of the largest costs of fund ownership.* Portfolio transaction costs—an inseparable part of owning most funds—are ignored, yet they add something like 0.8 percent per year to that 1.66 percent expense ratio, bringing the cost to 2.4 percent. Out-of-pocket costs paid by fund investors are also ignored. Fees paid to financial advisers to select funds (partly replacing those front-end loads) are also ignored. Opportunity cost—the long-term shortfall in the returns engendered by the cash reserves that nearly all equity funds maintain—is ignored. Put them all together and it is fair to estimate that the all-in annual costs of mutual fund ownership now runs in the range of 2½ percent to 3 percent of assets.

What does that mean? While 2½ percent may look like small potatoes compared to the value of a typical fund investment, such a cost could cut deeply into the so-called "equity-premium" by which investors expect stock returns to exceed bond returns, giving the average equity fund investor a return little more than a bondholder, despite the extra risk. Looked at another way, 2½ percent would consume 25 percent of an annual stock market return of 10 percent. Over the long-term, $1 compounded in a 10 percent stock market would grow to $17.50 over 30 years; compounded at 7½ percent—a fund's return *after* such costs return—would reduce that value by exactly one-half, to $8.75. *Costs matter!*

The astonishing rise in equity fund costs since 1950—despite the truly flabbergasting leap in fund assets, not just on new speculative funds but on old conservative funds—is one more indication that the fund industry has veered from its roots as an investment *profession,* moving ever closer to being just another consumer products *business.* Further disclosure of the total costs incurred by fund investors would be a much-needed first step in the long process of reversing this trend.

9. The March of the Entrepreneur

That the line between a business and a profession is an obscure one does not mean that it does not exist. We think of a business as an undertaking in which the principal purpose is to earn a profit for the owner, and a profession as an undertaking in which the provider's purpose is to serve clients. Nonetheless, it must be clear that every business must entertain some idea of service to others. (Without that element, the customers would go elsewhere.) And that every profession must

also, in some sense, make a profit. (Doctors and lawyers, after all, should earn a good living.)

But the industry that *Fortune* described all those years ago clearly placed the emphasis on fund management as a profession—the trusteeship of other people's money. The article is peppered with the words "trust" and "trustee," and frequently refers to the "investment-trust industry." Funds were largely middle-of-the-road in focus, diversified in investments, and built to last. Management fees were used to pay for, of all things, management. Costs were low, and distribution costs were paid not by the funds, but by the investors, as they purchased their shares. (M.I.T., for example, had its own employees (28!), no management company, and no economic or ownership interest in the company that distributed its shares.)

Today, it seems clear that marketing has superseded management as our industry's prime focus, the exact opposite of what I called for in my thesis. The industry spends, I would estimate, at least five *times* as much on selling as on supervision, contributing heavily to those soaring expense ratios. Advertising has gone from virtually nonexistent to pervasive (or at least it was until the onset of the great bear market). We have put aside our professional judgment and formed new funds when the investing public demanded then, and, when they outlive their usefulness or lose their performance luster, we give them a decent burial, happily consigning their records to the dustbin of history.

What caused the sea change in our industry? Perhaps it is that stewardship was essential for an industry whose birth in 1924 was quickly followed by tough times—the Depression, and then World War II. Perhaps it is that salesmanship that became the winning strategy in the easy times thereafter, an era of almost unremitting economic prosperity. Perhaps it is because as we became the investment of choice for American families fund shareholders, with no more efficient way to own stocks, bonds, and saving reserves, became less discriminating. Perhaps it was the very genetics of the capitalistic system that drives companies to compete and win. But I believe that the most powerful force behind the change was that mutual fund management emerged as one of the most profitable businesses in our Nation, with pretax profit margins that average 40 percent to 50 percent or more. *Entrepreneurs could make big money managing mutual funds.*

The fact is that, only a few years after "Big Money in Boston" appeared, the whole dynamic of entrepreneurship in the fund industry changed. In 1958, it became possible not only to make a tidy profit in managing money, but also to *capitalize* that profit by selling shares of a management company to outside investors. Up until then, the SEC had successfully defended its position that the sale of a management company represented the payment for the sale of a fiduciary office, an illegal appropriation of fund assets. Why? Because by allocating future advisory fees to whomever the manager might wish, a sale of the trustee's office would have taken place. If such sales were allowed, the SEC feared it would lend to "trafficking" in advisory contracts, leading to a gross abuse of the trust of fund shareholders.

But in 1954, a California management company, in effect challenging the SEC's position, sold its shares to an outside investor. The SEC went to court, and lost. As 1958 ended, the gates that had prevented public ownership for 34 years came tumbling down. *Après moi, le deluge!* The rush of public offerings began. Within 2 years, the shares of a dozen management companies, including some of the industry pioneers, were brought to market via initial public offerings. Over subsequent years, many others followed. Investors bought management company shares for the same reasons that they bought Microsoft and IBM and, for that matter, Enron, because they thought their earnings would grow and their stock prices would rise accordingly.

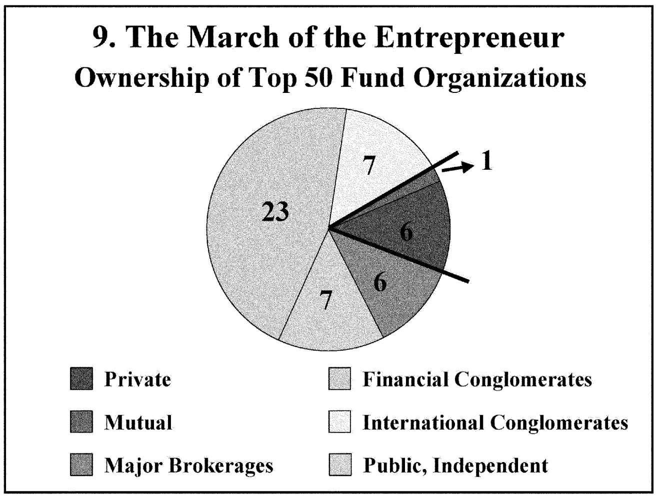
But the IPO's were just the beginning. Most of the companies that went public were ultimately acquired by other financial companies. Giant banks and insurance companies also acquired *privately held* management companies, taking the newly found opportunity to buy into the burgeoning fund business at a healthy premium—averaging 10 times book value or more. "Trafficking" wasn't far off the mark; there have been at least 40 such acquisitions during the past decade, and the ownership of some firms has been transferred several times. Today, among the 50 largest fund managers, only six(!) are privately held, largely by their executives.[3] Thirty-six are owned by giant financial conglomerates, including bank, stock brokers, insurance companies, and foreign financial firms. (In 1982, even the executives of M.I.T. and its associated funds sold the management company to Sun Life of Canada.) The seven remaining firms are publicly held.

It must be clear that when a corporation buys a business—whether a fund manager or not—it expects to earn a hurdle rate of, say, 12 percent on its capital. So

[3] While Vanguard is not included in this list, it is owned by the mutual funds it manages.

if the acquisition cost were $1 billion, the acquirer would likely defy hell and high water in order to earn at least $120 million per year. In a bull market, that may be an easy goal. But when the bear market comes, we can expect some combination of: (1) slashing management costs; (2) adding new types of fees (distribution fees, for example); (3) maintaining, or even increasing, management fee rates; or even (4) indeed, the overreaching by managers in the recent fund scandals was often done to enrich fund managers at the expense of fund shareholders. (The SEC's "trafficking" in advisory contracts writ large!)

It is not possible to assess with precision the impact of this shift in control of the mutual fund industry from private to public hands, largely those of giant financial conglomerates, and the change in the industry from profession to business. But such a staggering aggregation of managed assets—often hundreds of billions of dollars—under a single roof, much as it may serve to enhance the development, to whatever avail, of fund complex's "brand name" in the consumer goods market, seems unlikely to make the money management process more effective, nor to drive investor costs down, nor to enhance this industry's original notion of stewardship and service.



10. A Half-Century of Change: For Better or Worse?

In short, this industry is a long, long way from the industry described in "Big Money in Boston" all those years ago. While my characterization of the changes that have taken place may be subjective, the factual situation I have described is beyond challenge. This *is* an infinitely larger industry. The variety of funds *has* raised the industry's risk profile. The management mode *was* largely by committee but *is* overwhelmingly by portfolio manager. Fund turnover *has* taken a great upward leap. Fund investors *do* hold their shares for far shorter periods. Marketing *is* a much more important portion of fund activities. Fund costs, by any measure, *have* increased, and sharply. And those closely held private companies that *were* once the industry's sole modus operandi *are* an endangered species.

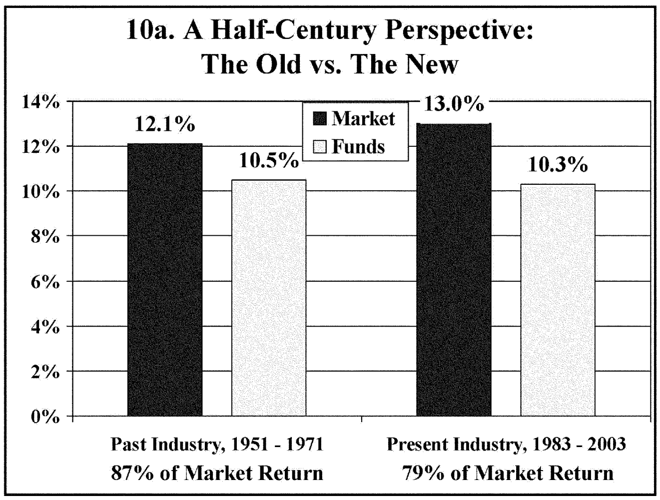
All this change has clearly been great for fund managers. The aggregate market capitalization of all fund managers 50 years ago could be fairly estimated at $40 *million.* Today, $240 *billion* would be more like it. Way back in 1967, Nobel Laureate Paul Samuelson was smarter than he imagined when he said, "there was only one place to make money in the mutual fund business—as there is only one place for a temperate man to be in a saloon, behind the bar and not in front of it . . . so, I invested in a management company."

At the start of this statement, I asked whether these nine changes have served the interests of mutual fund investors. Clearly the answer is a resounding no. It is a simple statistical matter to determine, using Dr. Samuelson's formulation, how well those on the other side of the bar in that saloon have been served, first by the old industry, then by the new.

- During the first two decades of the period I have covered today (1950–1970), the annual rate of return of the average equity fund was 10.5 percent, compared to 12.1 percent for Standard & Poor's 500 Stock Corporate Index, a shortfall of 1.6

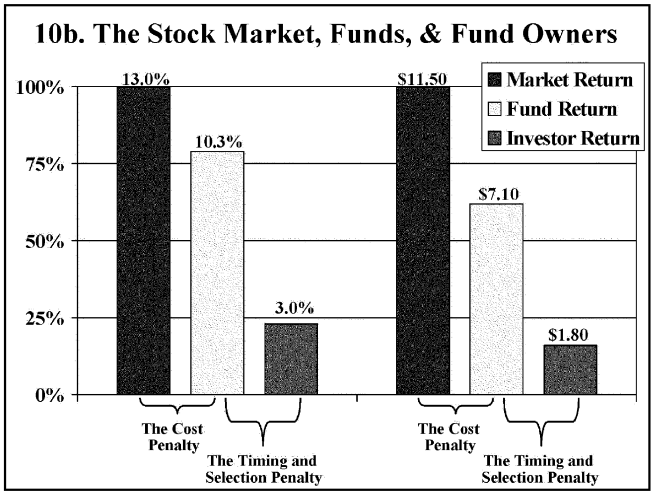
percentage points, doubtless largely accounted for by the then-moderate costs of fund ownership. The average fund delivered 87 percent of the market's annual return.

- During the past 20 years (1983–2003), the annual rate of return of the average equity fund was 10.3 percent, compared to 13 percent for the S&P 500 Index, a shortfall of 2.7 percentage points—69 percent greater than the prior period's—largely accounted for by the now-far-higher levels of fund operating and transaction costs. The average fund delivered just 79 percent of the market's annual return.



It is the increase in *costs,* largely alone, that has led to that substantial reduction in the share of the stock market's return that the average fund has earned. But it is the change in the industry's *character* that has caused the average fund *shareholder* to earn far less than the average *fund.* Why? First, because shareholders have paid a heavy *timing* penalty, investing too *little* of their savings in equity funds when stocks represented good values during the 1980's and early 1990's. Then enticed by the great bull market and the wiles of mutual fund marketers as the bull market neared its peak, they invested too *much* of their savings. Second, because they have paid a *selection* penalty, pouring money into "new economy" stocks and withdrawing it from "old economy" stocks during the bubble, at what proved to be precisely the wrong moment.

The result of these two penalties: While the stock market provided an annual return of 13 percent during the past 20 years, and the average equity *fund* earned an annual return of 10.3 percent, I estimate that the average fund *investor* earned just 3 percent per year. It may not surprise you to know that, compounded over two decades, the nearly 3 percent penalty of costs is huge. But the penalty of character is even larger—another 8 percentage points. *One dollar compounded at 13 percent grows to $11.50; at 10 percent, to $7.10; and at 3 percent, to just $1.80.* A profit of just eighty cents!



The point of this exercise is not precision, but direction. It is impossible to argue that the totality of human beings who have entrusted their hard-earned dollars to the care of mutual fund managers has been well-served by the myriad changes that have taken place from mutual funds past to mutual funds present. What about mutual funds yet to come? My answer will not surprise you. It is time to go back to our roots; to put mutual fund shareholders back in the driver's seat, to put the interests of shareholders ahead of the interests of managers and distributions, just as the 1940 Investment Company Act demands.

It Is Time For Change

It is time for change in the mutual fund industry. We need to rebalance the scale on which the respective interests of fund managers and fund shareholders are weighed. Despite the express language of the 1940 Act that arguably calls for *all* of the weight to be on the side of fund shareholders, it is the managers' side of the scale that is virtually touching the ground. To get a preponderance of the weight on the shareholders' side, we need Congress to mandate: (1) an independent fund board chairman; (2) no more than a single management company director; (3) a fund staff or independent consultant that provides objective information to the board; (4) a Federal standard that, using the Act's present formulation, provides that *directors have a fiduciary duty to assure that* "funds are organized, operated, and managed in the interests of their shareholders" rather than in the interests of "their advisers and distributors;" (The italicized language would be added to the statute.) (5) that boards of directors consider a mutual structure once a fund complex reaches a certain size.

In addition to legislation that will begin the process of reforming fund governance in the interests of fund owners, we also need better information for mutual fund shareholders, including: (1) annual statements that show the *actual dollar amount* of annualized fund expenses and portfolio transaction costs paid by each investor; (2) mandatory reporting, not only of the standard returns of an investment in a single share of the fund ("time-weighted" returns), but also the returns actually earned on the fund's total assets ("dollar-weighted" returns); (3) an economic study of the fund industry by the Securities and Exchange Commission showing all of the costs assumed by fund owners, and the itemized list of expenses incurred by their managers, as well as the managers' profits; (4) complete disclosure of all compensation paid to mutual fund executives, including total compensation paid to senior executives and portfolio managers, including their share of the management company's profits; and (5) an express requirement that compels advisers to provide, and fund directors to consider, the amount and structure of fees paid to the adviser by institutional clients. The disparities in these fees are shocking.

As I wrote 5 years ago in *Common Sense on Mutual Funds,* changes such as these would at long last allow independent directors "to become ferocious advocates for the rights and interests of the mutual fund shareholders they represent . . . they would negotiate aggressively with the fund adviser . . . they would demand performance-

related fees that enrich managers only as fund investors are themselves enriched. . . . They would challenge the use of 12b–1 distribution fees . . . and no longer rubber-stamp gimmick funds cooked-up by marketing executives . . . becoming the fiduciaries they are supposed to be under the law.''

Alternatively, and perhaps even more desirably, I then argued, the industry may require ''a radical restructuring—the mutualization of at least part of the mutual fund industry. . . . Funds—or at least large fund families—would run themselves; and the huge profits now earned by external managers would be diverted to the shareholders . . . they wouldn't waste money on costly marketing companies designed to bring in new investors at the expense of existing investors. With lower costs, they would produce higher returns and/or assume lower risks. But regardless of the exact structure—(a new) conventional form or a truly mutual form—an arrangement in which fund shareholders and their directors are in working control of a fund will lead . . . to an industry that will enhance economic value for fund shareholders.'' And it is in that direction that this industry must at last move.

* * *

Addendum: A Fair Shake for Federal Government Employees

It is a curious irony that the ''radical restructuring'' I called for in the final paragraph of my regular testimony is already in place for the employees of the Federal Government. The Thrift Savings Plan (TSP), established by Congress in 1986, is a defined contribution plan governed by their Federal Retirement Thrift Plan Board, an independent Government agency. The members of the Board are required by law to manage the Plan *prudently and solely in the interests of the participants and their beneficiaries.*

In effect, the TSP joins Vanguard as the second *mutual* mutual fund organization, operated on an ''at cost'' basis and managed for the benefit of its participants. TSP invests in fixed-income securities, stocks of large companies, small capitalization stocks, and international stocks, all ''indexed'' to track appropriate market benchmarks (for example, the Standard & Poor's 500 Stock Index). TSP has negotiated with Barclays the fees paid for those indexing services, which last year came to $4,270,000, equal to 0.005 percent, or just one-half of one basis point. (A basis point equals one-tenth of 1 percent.) Including administrative expenses, the Plan's ''expense ratio''—expenses as a percentage of average assets—was 0.07 percent (seven basis points).

As the attached table shows, TSP would have by far the lowest costs of the equity funds managed by the 25 largest equity fund managers—roughly 95 percent lower(!) than the average manager's expense ratio of 1.60 percent, and even 30 basis points below Vanguard's industry-low 0.37 percent equity fund expense ratio. (Vanguard's equity funds are both indexed and actively managed.) The TSP has been a remarkable success. Were it a conventional fund complex, its $129 billion of assets at the beginning of 2004 would mark it as the 13th largest firm in the industry.

TSP has provided enormous benefits to Federal employees, has operated in the way that Vanguard operates, has been *totally immune* to scandal or to any of the nine baneful trends described in my statement, and has served its owners well. The TSP large cap stock fund, for example, delivered an annual return of 9.29 percent to its investors during 1993–2002, *after all administrative expenses, management fees, and trading costs,* compared to the return of 9.34 percent of the (cost-free) Standard & Poor's 500 Index, a shortfall of just five basis points. The average equity fund, on the other hand, (see chart 10b) has tended to fall some 270 basis points per year behind the Index, creating a staggering shortfall in investment returns.

General mutual fund investors deserve to be as well-served as Federal Government employees. I believe the optimal way to encourage the industry to move in that direction is to enforce the objective of the Investment Company Act of 1940 that requires that funds be ''organized, operated, and managed,'' not in the interests of their managers and distributors, but solely in the interests of their shareholders, just as is the Federal Employees Thrift Savings Plan. I recommend that the Act be amended to include: (1) imposing upon fund directors an express statutory Federal standard of fiduciary duty to fund shareholders; (2) a requirement that no more than a single management company executive be eligible for membership on the fund's board of directors; (3) a requirement that the fund's chairman be an independent director; and (4) a provision empowering and encouraging fund directors to employ their own staff to evaluate the costs and returns achieved by their managers relative to other alternatives.

Expense Ratios of the Biggest Funds[1]

The expense ratios of the top 25 mutual fund families by net assets on 12/31/2003; includes only stock funds available to individuals.

		Expense Ratio	Assets (Bil)
1.	AllianceBernstein	2.22%	$ 30.33
2.	Federated	2.12%	18.61
3.	Van Kampen	1.98%	41.39
4.	AIM	1.95%	66.58
5.	Evergreen	1.92%	12.78
6.	Merrill Lynch	1.91%	25.58
7.	OppenheimerFunds	1.89%	56.07
8.	Hartford	1.87%	18.69
9.	Columbia	1.86%	21.89
10.	American Express	1.79%	40.33
11.	Pimco Funds	1.74%	14.34
12.	Franklin Templeton Inv.	1.73%	100.07
13.	Smith Barney	1.72%	33.66
14.	Putnam	1.71%	98.15
15.	MFS	1.69%	53.92
16.	Morgan Stanley	1.66%	28.48
17.	Scudder	1.64%	30.10
18.	Lord Abbett	1.64%	26.60
19.	One Group	1.56%	7.95
20.	Fidelity	1.49%	513.10
21.	American Century Inv.	1.45%	54.68
22.	American Funds	1.16%	393.38
23.	T. Rowe Price	1.03%	75.03
24.	Janus	0.98%	71.96
25.	Vanguard	0.37%	355.44
	Federal Thrift Savings Plan	0.07%	65.06

1-S urce: *New York Times*, February 8, 2004.

FUND OPERATIONS AND GOVERNANCE

TUESDAY, MARCH 2, 2004

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10:01 a.m. in room SD–538 of the Dirksen Senate Office Building, Senator Richard C. Shelby (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN RICHARD C. SHELBY

Chairman SHELBY. The hearing will come to order.

Today, this Committee holds its fifth hearing on reforming the mutual fund industry. We have two panels this morning.

On the first panel, we have Senator William Armstrong, my former colleague and the current Independent Director and Chairman of the Oppenheimer Funds; Marvin Mann, Chairman of the Independent Trustees of the Fidelity Funds; and Vanessa Chang, who is an Independent Director for the New Perspective Fund.

I expect the witnesses to further our understanding of fund governance practices and principles as we seek to ensure that mutual fund boards are properly armed to protect shareholder interests.

We will also hear from Michael Miller, who is Managing Director for The Vanguard Funds. Mr. Miller will discuss the issues surrounding the simultaneous management of mutual funds and other institutional accounts, such as hedge funds, by portfolio managers.

I am sensitive to the potential for conflicts that can arise through the side-by-side management of mutual funds and hedge funds. Like all potential conflict situations, these side-by-side arrangements must be subjected to close scrutiny under strong and active compliance programs.

I look forward to hearing whether, and how, fund advisers go about ensuring that fund shareholders are treated fairly and receive equitable share allocations.

The second panel will address the SEC's recent rule proposal aimed at halting late trading. As we learned from the recent scandals, late trading was all too common in the industry. In an effort to shut the window for late trading, the SEC proposed a rule that would essentially require all mutual fund trades to be reported to the fund or a registered clearing agency by 4 p.m. Eastern Standard Time.

This proposal is known as a "Hard 4 p.m. Close." Many contend that although the "Hard 4 p.m. Close" would deter late trading, it will have the unintended adverse consequence of limiting investors'

access to their mutual fund investments. This unintended consequence will be particularly unfair to 401(k) investors.

The witnesses will discuss how the "Hard 4 p.m. Close" will impact investors and will hopefully offer alternatives that deter late trading without unintentionally harming investors.

On the second panel, we will hear from Ms. Ann Bergin, Managing Director of the National Securities Clearing Corporation; Mr. William Bridy, President of Financial Data Services, a subsidiary of Merrill Lynch; Mr. Raymond McCulloch, Executive Vice President, BB&T Trust; and Mr. David Wray, President, Profit Sharing/401(k) Council of America. I look forward to your testimony.

Now, I want to recognize Senator Allard for a special recognition.

COMMENTS OF SENATOR WAYNE ALLARD

Senator ALLARD. Thank you, Mr. Chairman. I just want to take a moment to welcome the panel here and particularly one member on the panel, former Senator Bill Armstrong. Bill represented my State of Colorado—in fact, he represented the seat that I now hold here in the Senate—from 1979 to 1991. He spent 10 years of that time right here on the Banking Committee.

Chairman SHELBY. Some of it with me.

[Laughter.]

Senator ALLARD. He is recognized as somebody who is very thoughtful and who was extremely effective while he was here.

I also know he has not been particularly anxious to come back. It has been over a decade since he has testified before a committee or even had his words put on any kind of public record around here. He has certainly been a strong advocate of the free enterprise system, and I know that he recommends this Committee to new Members that come into the Senate. I had a discussion with him when I came to the U.S. Senate, and he recommended that I get on this Committee—that was a very good recommendation. I have never regretted that and have thoroughly enjoyed serving with you, Mr. Chairman, and serving on this particular Committee.

I just wanted to give him my special welcome. I am not going to be able to stay long because I am on the Budget Committee, so I won't be able to hear all your words this morning.

Mr. Chairman, I also have some comments I would like to have in the record.

Chairman SHELBY. Without objection, they will be made part of the record.

Senator ALLARD. Thank you very much.

Chairman SHELBY. Before I recognize the panel, I do want to add something else about Senator Armstrong. He served on this Committee. He was a senior Member of this Committee when I was a freshman Member, and my first 2 years on the Committee were your last 2 years in the Senate. He left by choice not by force. I told him the other day that if he had stayed here, he would be Chairman of the Committee and I would be one of his lieutenants. And I would gladly be so.

We have just been joined by Senator Hagel. Do you have any opening comments?

COMMENTS OF SENATOR CHUCK HAGEL

Senator HAGEL. The only comment I would make, Mr. Chairman, is to welcome our witnesses and, as you have noted, our former colleague and dear friend, Bill Armstrong. I might add that one of the reasons he is so smart and wise, he is a Nebraskan.

[Laughter.]

As is his wife.

Chairman SHELBY. You are all probably cousins in some way.

[Laughter.]

I could not resist.

Senator HAGEL. Mr. Chairman, thank you.

Chairman SHELBY. Senator Hagel, I think that both of you understand the business model and market forces.

Senator Armstrong, we will start with you. If you have written testimony it will be made part of the record. You know the Committee. Proceed as you wish.

STATEMENT OF WILLIAM L. ARMSTRONG INDEPENDENT MUTUAL FUND DIRECTOR AND CHAIRMAN, OPPENHEIMER FUNDS FORMER U.S. SENATOR (1979–1991)

Senator ARMSTRONG. Mr. Chairman, thanks very much. Thanks for the opportunity to be here. Thank you for your gracious comments. The financial services industry and thoughtful people all over the world are glad that I retired and you became the Chairman of this Committee. And I compliment you for your leadership.

Chairman SHELBY. Maybe I should retire and you would be the Chairman, if you would show me how the market forces work.

Senator ARMSTRONG. Mr. Chairman, I do not want to take too much time to say so, but I left because of illness and fatigue. I was afraid if I stayed too long, my constituents would get sick and tired of me.

[Laughter.]

I particularly want to thank my dear friend, Wayne Allard, for his comments. It just reminds me how much I appreciate his friendship and his service to the people of our State and country. And to Chuck Hagel, who has been a friend for, I guess, three decades and a person whom I have admired and appreciated, I thank Senator Hagel for his comments as well.

Mr. Chairman, I am an Independent Mutual Fund Director. I am the Chairman of 38 Denver-based mutual funds with about 5 million shareholder accounts and $75 billion in assets.

My colleagues and I on these fund boards have learned with mounting indignation that some people in this industry have betrayed the trust placed in them by shareholders. These people must be called to account. It seems to me that people who have violated their trust must be punished. And, in fact, as far as I am concerned, we should throw the book at them.

Having said that, it is important to keep in mind that all of the wrongdoing has been discovered and can readily be punished under existing statutes. What has happened does not, in my opinion, call for sweeping new legislation. In fact, some of the proposals which have been suggested—and I have reviewed 106 specific proposals contained in various legislative initiatives and regulatory pro-

posals—some of these actually end up punishing the shareholders. What an irony it would be if, as a result of the wrongdoing, we somehow ended up punishing the victims instead of the violators.

Now this is not to say that we should do nothing. Obviously, there is some action called for, and I take it for granted that Congress should and will act. I think the important thing, though, is to separate out what will help the shareholders because they should be, it seems to me, the paramount interest of this Committee and certainly the paramount interest of directors.

Mr. Chairman, broadly speaking, the things that will be good for shareholders are governance and disclosure, and I would like to just quickly address two or three items.

First of all, my colleagues and I in the fund industry—and I do not speak for all of them, but I must say, I have talked to a great many, probably the chairmen or directors of maybe 25 different fund families over the last few months. Most of us believe that independent directors are a good idea. We favor the concept of two-thirds or 75 percent of directors being independent, though I would urge caution in how this is implemented. In one case that I know of, an 11 member board has 10 members who are independent under present law, but if the definition was changed in accordance with some suggestions, suddenly people who are now considered independent would not be. And to get into conformity, it would require discharging a number of the present directors or actually adding 13 new directors to the board, which would produce a board too large to govern effectively; it would be unwieldy and not a desirable outcome.

We favor the independence requirement, but we want it either phased in or leave the definition alone just to avoid unintended consequences and either the loss of expertise or creating boards that are too large.

Many people in the industry favor the concept of an independent chairman. I am an independent chairman. I generally think that is a good idea. In fact, I happen to think independent chairmen are a good idea for most business corporations, not just mutual funds. But I cannot help but wondering: Why should this be mandated by law? Why shouldn't this be left up to individual boards of independent directors to decide whether they want to elect someone who is an executive or somebody who is an independent trustee? Why can't that just be left up to everybody?

Now, for example, if Mr. Mann's fund finds that he wants to have an executive chairman and our fund at Oppenheimer has an independent chairman, if that is fully disclosed, shareholders can make that decision. And if they decide that they do not like an executive chairman, fine, let them sell their Fidelity shares and buy Oppenheimer shares and vice versa. In other words, if the people know, they will work it out for themselves.

Which brings me to the whole topic of disclosure. We think truth is our friend, and with one exception which I want to mention, we favor disclosing everything, only to the extent that it does not become confusing to investors, but basically we think sunshine is great. We think that regulation is probably to the disadvantage of shareholders.

The one exception, the one place where I personally and my colleagues have some concern about disclosure is when it comes to disclosing the exact salary of a portfolio manager, which just puts such people on a shopping list for headhunters and will end up having people recruited out of the industry into hedge funds and other financial institutions.

Mr. Chairman, let me just close by saying this: In my written statement I have submitted commentary on a number of the issues that are pending, including things that have to do with the next panel. I will not go into them now, but I do want to say that my colleagues and I wish the Committee much success in your deliberations. The mutual fund industry is enormously important to America. Fifty-four million Americans have mutual fund accounts, with $7 trillion invested. It has been perhaps the most important, the most significant engine of wealth creation for most American families, particularly middle-income families who do not have the financial resources or access to hedge fund managers, separate accounts, or all of the investment vehicles that are available to the wealthy. They do not have that. But the mutual fund industry has made it possible through 8,200 funds for them to have a chance to create significant wealth, much to their advantage, but also to the advantage of the whole country because such people do not tend to become dependent upon the Government for help.

Mr. Chairman, we do wish you well, and needless to say, if my colleagues or I can ever be of help, we are eager to do so.

Thanks again for the opportunity to be here.

Chairman SHELBY. Thank you.

Ms. Chang.

STATEMENT OF VANESSA C.L. CHANG
INDEPENDENT DIRECTOR
NEW PERSPECTIVE FUND

Ms. CHANG. Thank you and good morning.

Chairman SHELBY. Pull the mike up to you a little bit, please.

Ms. CHANG. Okay.

My name is Vanessa Chee Ling Chang. I serve as an Independent Director, Chair of the Audit Committee, and a member of the Contracts Committee of New Perspective Fund, also known as NPF, a member of the American Funds family. The fund is advised by Capital Research and Management Company, and it has in excess of $30 billion in assets and is sold through third parties.

I appreciate the opportunity to appear before this Committee this morning to discuss mutual fund governance and my perspective as an independent director.

I am greatly dismayed by the abuses that have come to light in this industry over the last couple of months. In particular, I am distressed, like my colleague Mr. Armstrong, about the abuses that some industry participants have chosen to benefit themselves unfortunately at the expense of fund investors, causing the current crisis of confidence. Their behavior is so contrary to my experience with my fellow directors at American Funds, with the associates at Capital Research, and in particular, independent directors of other funds whom I have gotten to know and with whom I have had industry discussions.

I commend Congress' and the regulators' interest, especially the SEC, in restoring investor confidence and faith in our capital markets. Clearly, some regulatory response is necessary. I thank this Committee for your thoughtful consideration to determine what legislative response may be necessary.

My testimony this morning will focus on two areas: First, I will discuss the operation of a fund board and my experience in carrying out my duties and responsibilities as an independent director. Second, I will address some of the pending reform proposals that could affect the duties of an independent director on fund boards and provide my views on whether they could enhance or hinder our oversight role.

A shareholder invests in a mutual fund because the investment strategy and process of the adviser is attractive to that individual investor. In fact, the investment adviser created the mutual fund to offer its services on a pooled basis to the investing public who otherwise could not possibly afford the services of a professional money manager.

Fund directors are subject to State law duties of loyalty and care. We are also subject to additional specific duties under the Investment Company Act of 1940 and the SEC. These responsibilities typically include monitoring for conflicts of interest between the fund and its adviser and other service providers. One prominent example of the independence role in protecting against conflicts is the annual renewal of the adviser's contract.

A mutual fund has no employees and, therefore, contracts out for all its services. Accordingly, the mutual fund board must continually focus on the quality of those services and determine whether the fund has received fair value. The adviser and service providers manage its operations and provide staff. As fund directors, we are not charged with managing any of the fund operations. We serve, however, the interests of fund shareholders through our oversight of the fund's operations and of the fund's service providers such as the adviser, the auditors, lawyers, and the like.

At NPF, active oversight of the fund's investment adviser is the heart of our work. We receive monthly briefings that address the business, industry, and regulatory developments amongst other items of interest, and especially in connection with the annual contract renewal. We review and discuss information provided by the adviser over two board meetings. I have never felt inhibited in asking questions or raising issues that were either not on the agenda or not in the book.

Only the independent directors, together with our independent counsel, meet in executive session to discuss all of the information in connection with this contract renewal. Only after we are all satisfied do we vote on the advisory contracts. All independent directors sit on the Contracts Committees, and only we vote on the contract matters.

My duty as a director is to feel comfortable not just at one point in time. As a result, throughout the year, I look for or request information that satisfies me that the controls, systems, policies, and procedures necessary to protect the fund's investors continue to be in place. Our board regularly takes the initiative to identify mat-

ters for the adviser to report on at the board meetings or in special sessions. Management is always responsive to our requests.

Attendance at our board meetings and committee meetings is almost always 100 percent. My fellow directors diligently do their homework, as evidenced by the tough and probing questions. Independent directors are nominated by the Nominating Committee that consists of only independent directors. We have a separate committee consisting of one independent director from each of the nine clusters to oversee the shareholder operations performed by a subsidiary of Capital Research. This committee meets biannually with at least one meeting taking place at one of the four service centers.

Now, I would like to mention a couple of examples of the reforms that I consider beneficial and most likely will have an impact on how I discharge my duties as an independent director.

I support broadening the definition of "interested person," requiring 75 percent of the board be independent, self-assessing the board performance annually, separate independent director meetings at least four times a year, and requiring the chief compliance officer to report directly to the independent directors.

On the matter of the independent chair, I do not support the proposal that every mutual fund board must have an independent chair. In fact, I support choice. Other alternatives that would strengthen the board equally well, for example, use of a lead director, combined with 75 percent independent directors, independent nominating committees, and the ability to contribute to the agenda and control the board discussion.

American funds have nine clusters ranging from 1 to 12 funds per cluster. For example, the Fixed-Income funds consist of 12 funds, while my cluster has only one fund. I serve on only one board, but our board meetings coincide with two other global equity funds—EuroPacific Growth Fund and New World Fund. We meet quarterly over consecutive days, and we oftentimes have joint board and Audit Committee meetings.

I like the efficiency and economies of scale provided by these joint meetings. It is my impression that directors serving on multiple boards benefit in much the same way. I do not believe the Congress or the SEC should dictate the number of boards an independent director can sit on. There are too many subjective influences, subjective factors to influence this. Instead, I think that the annual review of the board's performance will oversee this matter in an effective way.

With the matter on certification requirements, I understand that the independent directors or an independent chair is proposed to certify on a number of matters. I strongly believe an independent director should not be required to certify matters about which directors have no direct knowledge.

In particular, I am troubled by proposals that will require independent directors to certify that a fund is in compliance with its policies and procedures to calculate daily net asset values and oversee the flow of funds into and out of the fund.

I inquire and am satisfied that there are controls, procedures, and policies in place to calculate net asset values and oversee those fund flows. But neither I nor my fellow directors would be able to

certify that that fund is in compliance with those procedures on a daily basis. It is my view that these certifications, if required, should be directed to those persons who are responsible for managing the operations.

Putting this responsibility on directors would confuse our role as overseers with day-to-day managers. Moreover, should these certifications come to pass, it would be difficult to retain and to attract responsible, conscientious people to serve as board members.

I have found these people, independent board members of other funds and my fellow directors, to be smart, conscientious, inquisitive, and outspoken.

Thank you, Mr. Chairman.

Chairman SHELBY. Mr. Mann.

STATEMENT OF MARVIN L. MANN
CHAIRMAN OF THE INDEPENDENT TRUSTEES
THE FIDELITY FUNDS

Mr. MANN. Thank you very much, Chairman Shelby, Ranking Member Sarbanes, and Senator Hagel. I am Marvin Mann, Chairman of the Independent Trustees of the Fidelity Funds. I appreciate this opportunity to appear before you today to discuss mutual fund governance and how the Fidelity Funds Board does its job. It is a challenge to do this in 5 minutes.

Today, I am speaking on behalf of the Governance and Nominating Committee of the Fidelity Funds. First, I would like to touch on recent proposals, including those of the SEC, designed to improve fund governance, and I will do that briefly.

The SEC's proposal contains several requirements, most of which I support. Three of the more significant would require that independent trustees constitute 75 percent of a fund's board, undertake an annual self-evaluation, and meet separately from management at least quarterly.

One proposal that I do not support is a requirement that the board chairman be an independent trustee. A fund's independent trustees should, however, have the authority to elect and remove the chairman.

There are also legislative proposals that would require independent trustees to certify as to certain matters, such as the existence of certain procedures. I would not support such a requirement. For public companies' certifications are the responsibility of management, not directors. A certification requirement would create uncertainty as to the trustee's duties and potential liabilities.

I do believe that there are measures that should be taken to improve mutual fund regulation. In my written statement, I outline three proposals that address fund expense disclosure, soft-dollar arrangements, and arrangements for distributing fund shares. Frankly, I think that these could be very meaningful actions if carefully considered. And if time permits, I would be happy to discuss these proposals further.

Now, I would like to turn to how the Fidelity Funds Board exercises our fiduciary duties in our oversight of the 292 funds that we are responsible for.

First, we accomplish this through five attributes that characterize well-functioning boards: The right people, spending the

amount of time that is required, the time commitment, the authority to set the agenda, access to information, and the right organizational approach.

Having the right people is critical. Ten of the 14 trustees of the Fidelity Funds, or over 70 percent, are independent. The Governance and Nominating Committee, which is composed exclusively of independent trustees, is responsible for all aspects of independent trustee recruitment. We recruit people who are highly experienced at managing large, complex organizations, who are independent in fact and are prepared to be adversarial, who have the highest personal integrity, and who are able to meet the significant time commitment.

Let me pause a moment on this last point. The Fidelity Funds Board has regular meetings 11 times a year. Meetings take two long and very full days. A significant amount of time is required to prepare for these meetings.

Independent trustees must have a strong voice in setting the agenda for board and committee meetings. We approve an annual calendar that lays out the essential agenda items for the entire year. Then each month we add additional matters to the agenda for that month's meeting.

Information and organization are critical. The Fidelity Funds Board has a well-defined committee structure that is a key factor in our ability to oversee the Fidelity Funds and obtain the information we need to carry out our duties. The structure, mission, and membership of each board committee are decided solely by the independent trustees. These committees are chaired by and consist exclusively of independent trustees.

We have 10 committees that address the numerous responsibilities that require our attention. For example, we have three fund oversight committees, each of which oversees a specific category of funds and focuses primarily on fund performance. These fund oversight committees provide a good illustration of how our committee structure works.

The independent trustees receive monthly reports on the performance of all funds. Now these are graphs and charts, so it is easy to quickly identify funds that are not performing as they should be. This includes information comparing the performance of each Fidelity fund to a peer group of funds and to appropriate securities indices.

Each fund oversight committee conducts regularly scheduled, in-depth reviews of the funds it is responsible for. Prior to each fund review meeting, the board receives written reports and analyses from the portfolio manager. This material provides the independent trustees with essentially the same information that Fidelity management uses in its periodic review of its portfolio managers.

At a typical fund review meeting, the Oversight Committee discusses this data and other aspects of fund performance in-depth with the portfolio managers and their supervisors. Topics include the fund's compliance with its investment objectives and its performance, and the highlights of these meetings are reported to and discussed by the full board.

The fund oversight committees focus on matters unique to each fund. In contrast, there are a number of operational elements that

are generally common to all funds, such as processes related to brokerage allocation, fund operations, accounting, and compliance, and so on. Several of our committees focus on these common elements.

Given the limits of time, I regret that I cannot provide a more complete overview of how we do our job, but I have described one process that gives you some insight into how we exercise our fiduciary duties for the benefit of shareholders.

I appreciate the opportunity to share my views, and I would be happy to respond to your questions about these and any other issues. And I respectfully request that my entire written statement be included in the record.

Chairman SHELBY. Without objection, it will be made part of the record, Mr. Mann.

Mr. Miller.

STATEMENT OF MICHAEL S. MILLER
MANAGING DIRECTOR, THE VANGUARD GROUP, INC.

Mr. MILLER. Chairman Shelby, Ranking Member Sarbanes, and Senator Hagel, my name is Mike Miller. I am a Managing Director at The Vanguard Group, where my responsibilities include selecting and overseeing third-party investment advisory firms that manage assets for our funds, as well as for our corporate compliance function.

Vanguard understands that in the wake of fund trading scandals there is some interest in imposing a direct ban on the ability of an individual to manage both hedge funds and mutual funds, sometimes referred to as side-by-side management. Congress is properly considering this and other issues relating to the operation and the regulation of mutual funds. Vanguard appreciates the opportunity to testify today.

Although Vanguard does not manage or offer hedge funds, we are very concerned that a ban on side-by-side management will eliminate a substantial number of investment professionals that would ordinarily be available to our shareholders. Like Congress, Vanguard is concerned about protecting the interests of mutual fund shareholders. We believe that there are ways to effectively protect the interests of mutual fund clients without taking the extraordinary and potentially damaging step of an outright ban on managing both hedge funds and mutual funds.

Let me provide just a quick background on Vanguard. We are the world's second-largest mutual fund family with more than 17 million shareholder accounts and approximately $725 billion in our 126 U.S. mutual funds. Investment professionals on our own staff manage about 70 percent of Vanguard's assets. The remaining $220 billion or so are in portfolios managed by third-party investment advisory firms, which are hired and overseen by the funds' boards of trustees with substantial assistance from Vanguard's professional staff. In all, 37 of our funds receive portfolio management services from 21 independent advisory firms. We have been selecting and overseeing independent advisers for more than 25 years.

At many investment advisory firms, including Vanguard, other mutual fund companies, and all the third-party advisers we use, individual portfolio managers run multiple accounts for multiple clients. Besides mutual funds, these may include separate ac-

counts, bank common trust accounts, collective trusts, and in some cases hedge funds. Managing money for multiple clients has always been an inherent feature of successful asset management firms. None of the sub-advisers we have hired manages money solely for Vanguard. Importantly, any firm that manages mutual fund assets is a registered investment adviser and as such should have in place policies and procedures that help ensure that the investment professionals manage multiple accounts in the interest of all of their clients.

Mutual fund shareholders are protected by a number of practices today including internal controls and Federal regulation. At Vanguard, the protections for fund shareholders start, of course, with careful selection of advisers in the first place. Once an adviser is hired, we continually review the performance and portfolio characteristics of the funds, as well as the investment practices and compliance policies of the adviser.

All of our third-party managers are subject to periodic audits by Vanguard. Every firm that manages mutual fund assets must be registered under the Investment Advisers Act and is a fiduciary under both State and Federal law. Simply stated, this means the adviser has a duty to recognize and disclose potential investment conflicts and to manage them appropriately. These potential conflicts are not unique to advisers who provide investment management to mutual funds and hedge funds. They exist whenever a portfolio manager advises two accounts that differ in any way, potentially even two different mutual funds.

Investment firms typically manage potential conflicts through allocation policies and procedures, internal review processes, and oversight by directors and independent third parties. Trade allocation systems and controls ensure that no one client is intentionally favored at the expense of another.

In addition, the SEC has very recently enacted new rules that will raise industry-wide standards for addressing potential conflicts for the protection of all investors. These changes are discussed in my written testimony.

Banning individual portfolio managers from managing mutual funds and hedge funds would disadvantage and fail to fully protect mutual fund shareholders.

Allowing side-by-side management of mutual funds and other accounts, including hedge funds, affords mutual fund investors access to top investment firms and professionals. The supply of exceptional investment professionals is limited. It is important that all investors, including mutual fund shareholders and 401(k) plan participants, who largely invest in mutual funds, have access to the same universe of investment expertise available to large institutions or wealthy individuals.

Many mutual funds with strong long-term performance records are managed by portfolio managers who also invest for other accounts, which may include hedge funds. These managers can choose where to commit their time and their talent. Hedge funds can be an attractive option because they allow the use of a broader range of investment techniques and provide an opportunity to earn higher fees based on performance.

To the extent that a ban causes investment professionals to move on to accounts not subject to the ban, mutual fund investors would experience higher portfolio manager turnover. Continuity and stability benefit mutual fund investors. In our experience, they are among the key determinants of long-term investment success.

A better way, in our opinion, to address concerns about conflicts of interest is to strengthen compliance procedures, reporting, and oversight. For example, mutual fund directors should be required to review and approve stringent procedures to address conflicts of interest and to review an adviser's performance under those procedures. Advisers should be required to demonstrate to mutual fund boards that they have successfully followed their procedures.

Congress and regulators have responded to recent events by demanding more specific protections. The SEC recently strengthened the position of fund directors in this regard by requiring that every mutual fund have a chief compliance officer reporting to the directors. Each investment adviser must now have written policies and procedures for a number of matters, including allocation of trades among multiple clients. Fund boards must approve the policies and procedures of their advisers. In addition, the SEC has recently proposed that mutual funds explicitly authorize their independent directors to hire employees or other experts to help them fulfill their fiduciary duties. We support requiring this authority for directors.

We believe that the combined effect of enhanced compliance obligations and additional support for independent directors will protect investors. An outright ban would be a drastic solution in our opinion, especially in light of recent efforts to impose more stringent requirements.

Thank you, Mr. Chairman. Vanguard does very much appreciate the opportunity to testify today, and we would ask that our written testimony be included in the record.

Chairman SHELBY. Thank you, Mr. Miller.

My first question is for the directors. Many people contend that an independent chairman is critical to facilitating a vigorous and challenging boardroom culture. The chairman of any board controls the agenda, as you well know, and information flow. Would you describe your experiences with either insider or independent fund chairmen? What are the benefits and the negatives? Also, how do you address the assertion that an independent chairman requirement is a justified safeguard in light of the inherent conflict of interest between the adviser and the fund?

Senator Armstrong.

Senator ARMSTRONG. Well, Mr. Chairman, I happen to think that in most cases an independent chairman is a good idea. The chairman does set the agenda——

Chairman SHELBY. You are an independent chairman.

Senator ARMSTRONG. I am an independent chairman, and I will just note for the record that I was elected chairman long before that became a battle cry because of recent developments.

Chairman SHELBY. How large a fund is Oppenheimer?

Senator ARMSTRONG. The funds that I am Chairman of are 38 funds with about $75 billion under management. We are not one of the biggest, but we are certainly not one of the smallest either. And there is no doubt that the Chairman has——

Chairman SHELBY. You have not been involved in the problems either, have you?

Senator ARMSTRONG. No. And thank you for noting that, Mr. Chairman.

Chairman SHELBY. Okay.

[Laughter.]

Senator ARMSTRONG. Happily, we have escaped that notoriety.

I think the issue, however, is not whether I happen to think it is a good idea. I happen to like strawberry and vanilla, but I do not think we should outlaw chocolate.

Chairman SHELBY. I agree.

Senator ARMSTRONG. And if there are some people who strongly feel that an executive chairman, a member of the management team, is a better choice for a particular fund under particular circumstances, and if that is well disclosed, then I say let the investors decide that.

Chairman SHELBY. Mr. Miller.

Mr. MILLER. Vanguard would fully support Mr. Armstrong's position. We today have seven directors on our board—one of whom is an interested director, our Chairman and CEO Jack Brennan; the other six are independent directors. So about 85 percent of our directors are independent. We feel very strongly that when the rules require that there be a supermajority of independent directors, then one should let those directors decide and use their judgment and their discretion to decide who is best to serve as chairman of the board. And so we very much believe that the fund boards should make that determination.

Chairman SHELBY. Mr. Mann.

Mr. MANN. Mr. Chairman, I would perhaps make the comment that the independent trustees should be able to select the individual that they feel is most qualified to do the job, whether it be an insider or an independent trustee.

The major considerations I find are whether you are able to have control over the agenda, whether you are able to structure the board the way it needs to be structured to get your job done, whether you have the ability to have independent trustee meetings so that you can resolve issues where there are conflicts with management, and whether you have an organization and a staff that is open and willing to provide all of the information you require to be able to make the judgments that you have to make. That information must be provided in a format that is requested and is efficient to use. And if you have those things, I do not think it really matters whether the board has an independent chairman or not.

You see, the board meeting itself is not where the work gets done. I suspect it is a little like the work here. The work gets done in committees, and the committees are independent trustees.

Chairman SHELBY. But doesn't the board set the agenda in a sense, the broad agenda?

Mr. MANN. The board sets the agenda, and I can tell you specifically how it works at Fidelity. We have this annual calendar that I mentioned that prescribes the required things that we must do. Then on a monthly basis, early in the month, prior to the board meeting, we work out specific topics that we want to include in the next meeting. The Fidelity people put that agenda together because

their staff does the work. They contact me. I get input from the chairmen of the committees. And whatever we suggest gets on the agenda. There is no debate about it.

Chairman SHELBY. Thank you.

Mr. Miller, the dramatic compensation differences between the mutual funds and hedge funds create an incentive for portfolio managers to favor hedge funds, or they seemingly would. If this is true, how do you ensure that in your case Vanguard's shareholders receive fair treatment? Are there processes to manage the conflict of interest and ensure equitable share allocations here? If so, how do you do it?

Mr. MILLER. Mr. Chairman, there are clearly conflicts, potential conflicts of interest between hedge fund managers and mutual fund managers when they are the same individual, as there are with other kinds of accounts, not just hedge funds, separate accounts—I mentioned some in my oral statement.

We work judiciously to ensure that our outside managers that may run hedge funds, as well as money for Vanguard shareholders adhere to compliance procedures, policies, written guidelines, and codes of ethics. Under the law itself, there is a fiduciary duty that requires that you manage money in a way that does not disadvantage any client over another. And so it is a combination of using the professional staff of Vanguard—for example, at Vanguard we have a group called the Portfolio Review Group, which is about 25 individuals, mostly MBAs, CFAs, and CFPs. They work closely with the outside advisers. They help, you know, in the selection, the monitoring of what those advisers do for our fund shareholders, performance issues, things of that sort. Then we meet with our outside managers on a regular basis. They come to Vanguard and meet with senior management. They come to Vanguard periodically to meet with our board of directors. We go to their shops. We monitor their own procedures, their own policies, to ensure compliance, to ensure that there is no favoritism of one client over another.

We have long-term relationships with our managers. We are confident that they understand the protocol, the rules, the procedures, what is required by law. We go beyond our confidence to inspect, to enforce, to audit. And they know as a manager for Vanguard that at any time they are subject to our inspection and our audit activities to ensure they are managing money correctly on behalf of all investors fairly.

Chairman SHELBY. Senator Sarbanes.

COMMENTS OF SENATOR PAUL S. SARBANES

Senator SARBANES. Thank you, Mr. Chairman. I want to join with you in welcoming the panel and, in particular, our former colleague Bill Armstrong. It is very good to see him back in the Committee room, although at this time on the other side of the table.

I am interested in this issue of the independent directors and the independent chairman and how that decision is made. The SEC has put out a rule proposing that 75 percent of the directors be independent. What is your reaction to that, very quickly?

Senator ARMSTRONG. Mr. Chairman, our board supports that, I think most directors do, but with this caveat: That if the definition is simultaneously changed, that is, the definition of interested or

independent directors is changed, it could have some unforeseen consequences.

In one case I know of, it would literally—in order to meet the 75 percent requirement instantaneously, the board would have to discharge several of its existing members who are presently considered to be independent, or add 13 new members to an 11 member board, creating a board so large that it would not be functional.

So if Congress decides, as I expect they will, to require two-thirds or 75 percent, which we favor, we would ask that there be a long phase-in period to accommodate the natural retirement of members who would otherwise be lost to the process, lose their expertise.

Senator SARBANES. Ms. Chang.

Ms. CHANG. I do support the 75 percent independent director proposal. In fact, on our fund, we exceed that.

With respect to the definition of interested director, I actually like that proposal. I like the definition to make it clearer of what an independent director is and their prior relationships with service providers.

Senator SARBANES. Mr. Mann.

Mr. MANN. The tightening up of the definition of independent director we think is very good. At Fidelity, 70 percent of the directors—or 71 percent, to be precise, are independent, truly independent trustees. The additional 5 percent, the 75 percent, would require us to either add independent directors or drop one insider off the board, who we would not be excited to lose from the board because they make contributions to the board. But at the next board meeting, we would probably comply after we were told that that was the rule, and we would be okay with that.

Senator SARBANES. Mr. Miller.

Mr. MILLER. Senator Sarbanes, we also at Vanguard would support the SEC's proposal. As you know, the law has long required that there be a majority of independent directors on the board. The SEC now says let's take that to 75 percent. We would be very much in favor of that. As I noted, we do not favor the chairman necessarily being independent, but we do believe that the 75 percent proposal makes sense. We do at Vanguard favor a strict definition of independence and would not be in favor of permitting close relationships to fall within the definition.

Senator SARBANES. Let me ask all of you this question, because I am interested in your answers, which, of course, range a bit. We have established the Securities and Exchange Commission. It has five Commissioners. They have to be appointed by the President and confirmed by the Senate. We think we look for quality in picking Commissioners, and at the moment I think most of us think we have quite a good Commission at work.

Traditionally, the SEC has had a very good reputation, although it has had its ups and downs. It has a highly professional staff, a lot of expertise and a lot of technical competence.

Should we make these decisions we are talking about by statute in the Congress as opposed to the SEC making them by regulation? The SEC has a broad grant of authority, as witnessed by the fact that they are proposing various rules and regulations now to address some of the problems in the mutual fund industry. They have a staff that is looking into it. We are giving them more money.

They are going to have an upgraded staff. Suppose the SEC were to decide two-thirds. Should we pass a statute requiring three-fourths? Why not?

Mr. MANN. I would say broadly that of all of the things that we are discussing here, my counsel has been that all of these, perhaps with one exception, one of the things I am recommending, could be done by the SEC. The SEC has a very good process of putting out a proposal and asking for comments. There is a lot of back and forth and a lot of debate, a lot of enlightenment in the process that assures that the implications of those rules are well understood and that there will be a proper transition period during which it can be implemented, et cetera. And I think it works very well.

So, I think the Senate Banking Committee should give its direction and its ideas to the SEC and then encourage the SEC to act.

Senator SARBANES. Does anyone want to add to that?

Senator ARMSTRONG. Well, Senator Sarbanes, I agree with the implication of your question that the Senate would be wise to set the policy but leave the detailed regulation to the SEC, for all the reasons that you mentioned in your question. But on that same topic, there is floating around an idea of an oversight board which would be a separate and new regulatory body. Personally, I think that would be the worst outcome because if you put the regulation of the mutual fund industry in a new board and leave the regulation of the securities industry and the brokerage industry in a board over here, we end up fragmenting the process rather than integrating it and making it strong.

I have met recently with the Chairman of the SEC and members of his staff, and I sense a great vigor, a great enthusiasm for the task, and I believe that in most cases, as your question suggests, in most cases Congress can look to the SEC with confidence for the solution. Where that cannot happen, where there is doubt about their authority, then, of course, you would want to act or clarify their authority in some way.

Senator SARBANES. But where they have authority, you think we should defer to it as the expert body?

Senator ARMSTRONG. I do, and I think——

Senator SARBANES. Now would you all take that position with respect to the independent chairman?

Mr. MILLER. I will jump in here, because I do agree with what my colleagues have said, Senator, with respect to your question about legislation versus regulation. The SEC has proposed an independent chairman.

Senator SARBANES. They have proposed it. But they have not adopted it yet, and you all presumably are commenting about it.

Mr. MILLER. Yes, sir, we will be commenting.

Senator SARBANES. What is our role here? Should Congress move in now and start legislating all these various standards, or should the Congress say, "well, you know, this is why we set up the SEC, this is why we have jumped their budget, just shy of doubling it in 3 fiscal years." We have this expertise and professionalism. But there are some times, I say, "I might have not made that decision that way myself, but there are enough pros and cons on both sides that if the expert body makes the decision that way, I am prepared to accede to it and to give them their role." It is not only the SEC

we have set up this way, but we also have set up the Financial Accounting Standards Board to set accounting standards.

Then the issue becomes, is the Congress going to legislate accounting standards if the board seems to be moving in a direction that people do not like? So there is a one-stage-removed dimension to all of this, and I want to get from you what you see. Do you want us in there doing all of these things? Or do you want us sort of holding back and giving the Commission the chance to do its job? They have, I think, by and large, a very good process worked out for reaching the decisions, by proposing rules, taking comments, and reviewing the comments, it has struck me as being a thoughtful process. I think the industry generally agrees with that.

Mr. Miller.

Mr. MILLER. Senator, absolutely, I believe you have summed up quite nicely the position this Committee and Congress should take. The SEC is there, and it has been there for a long time. It works closely with the industry. At times, the SEC may propose a rule that the industry or members of the industry would disagree with, but that is the process.

I believe it is highly appropriate for the Congress, for this Committee, to weigh in with the SEC in terms of your beliefs, your judgments, your opinions. But I would defer to the expertise of the SEC and allow them to be the body that governs our industry, the rulemaking body.

Mr. MANN. I agree.

Ms. CHANG. I agree, too. In addition, with respect to the independent chairman issue, just as your question was the legislative versus the regulatory process, there needs to be a balance. On the independent chairman issue, there are funds out there whose shareholders may not be well-served. In our situation, we have an interested chairman, and it is because of his or her day-to-day knowledge, they are able to anticipate problems and to deal with them well in advance because of their day-to-day knowledge.

Thank you, Senator Sarbanes.

Senator SARBANES. Thank you.

Chairman SHELBY. Senator Bennett.

COMMENTS OF SENATOR ROBERT F. BENNETT

Senator BENNETT. Thank you very much, Mr. Chairman.

I am delighted to have Senator Sarbanes go down the road he is because we are——

Senator SARBANES. I am just asking hypothetically.

[Laughter.]

Getting the benefit of the witnesses' wisdom here.

Senator BENNETT. Particularly in this session of Congress, the idea that we do not have to do something is quite appealing.

But I do think we have a role to play in these hearings as we set a record and get the combined wisdom of our witnesses. And while I agree with Senator Sarbanes on FASB and the SEC and so on, I do ultimately reserve the right as a Member of Congress to yank their chain a little, pull back their authority a little. They are, in fact, creatures of the Congress, that is the Congress created them. And the Congress createth, the Congress can taketh away.

I would hope that we do not put ourselves in the position of saying we will never, ever take a position here.

I think that the role of this Committee in this situation is to hold hearings of this kind, get your comments on the record, and, frankly, I think they have more impact on the record before the Banking Committee and our comments on those comments than they do in the dry filing being sent over to the SEC.

I am perfectly willing to leave this one to the SEC. I agree that they are competent to do it. I do have some concerns about potential rigidity of an independent chairman and the definition of what is an independent chairman.

So in the spirit of what I have just said, to get it on the record with our reactions, can you describe for me the difference between an independent chairman and an interested chairman? I do know the difference between uninterested and disinterested.

[Laughter.]

But I do not know the difference between independent and interested in this context, and I think it would be good for the record to have that discussed. Yes, sir?

Senator ARMSTRONG. Senator, so far as I know, the term "independent" does not appear in the statute. The term that appears is "interested." But they mean the same thing in everyday usage, so far as I am aware.

By the way, I agree with everything you just said.

Senator BENNETT. Well, I thought that "independent" meant "disinterested."

Senator ARMSTRONG. Pardon me?

Senator BENNETT. I have always thought that "independent" meant "disinterested."

Senator ARMSTRONG. Yes, that is correct.

Senator BENNETT. But this is interested, so by definition, it is not the same thing as disinterested?

Senator ARMSTRONG. I apologize. I jumped to a conclusion I should not have. "Interested" is what I understand to be described in the statute, and a person who is independent is said to be "disinterested."

Senator BENNETT. I see.

Senator ARMSTRONG. Perhaps I am not responding to the question that you are asking.

Senator BENNETT. No, no. This is helpful. You are. So, you are saying the current statute says you have to have an interested chairman?

Senator ARMSTRONG. No. The current statute is silent on that.

Senator BENNETT. Is silent, so the proposed rule says you have to have an interested chairman.

Senator ARMSTRONG. Yes.

Senator BENNETT. A disinterested chairman.

Senator ARMSTRONG. I beg your pardon.

Senator BENNETT. Okay.

Senator ARMSTRONG. The point that you made which I thought was very significant was the idea of retaining authority in this Committee and in the Senate, and the Congress, to supervise the process, but deferring, as Senator Sarbanes had suggested, to their expertise and also to the fact that they have the time to do a

thoughtful job. I think that is a very significant point, and forgive me for leading you into an intellectual cul-de-sac on the distinction.

Senator BENNETT. No, you are helping to clarify.

Ms. Chang.

Ms. CHANG. Senator Bennett, "independent," or "disinterested," and "interested" is really two things. They are independent and disinterested in fact as well as in mind. And as I said in my oral earlier, I do not support a mandate for an independent chairman.

However, we have an interested chairman, but the individual allows us to control the agenda, to add items to that, and he allows us to control the discussions. So although he may be interested in fact, he is actually allowing the board the freedom to discuss what we want to discuss and the freedom to request the information we need in order to protect the fund's investors.

Senator BENNETT. Well, I know how majorities are formed, and it seems to me if independence controls 75 percent of the seats, even if the chairman says I want this on the agenda, a quick motion and vote and the agenda gets changed. So, I am not quite sure how essential it is that the chairman be an independent chairman.

Ms. CHANG. I agree with you.

Senator BENNETT. Okay. Any other comment?

Mr. MILLER. At Vanguard, Senator, we have as our Chairman of the Board our CEO. He is clearly not independent under the standard that the SEC uses. He is clearly affiliated with Vanguard. He runs our company. He is our CEO.

There are standards that govern how independent directors, disinterested directors, not-interested directors, however you want to say it, are defined. Things that, for example, if you formerly worked with a fund complex and retire, and then the next week go onto the board, you would not be considered an independent director. There has to be a passage of a certain amount of time. And there are proposals in some quarters that there be a tightening up of that definition to make it a stricter definition so that there would not be close relationships allowed to be independent directors. As I said earlier, Vanguard would favor those proposals and the tightening up of the standard.

But today at many fund companies, there is an independent chairman. At some fund companies, there is a nonindependent chairman. I think many complexes—Vanguard would be one of them, although we have as the chairman of our board our CEO, we have a lead outside director, a lead independent director that works closely with our chairman and CEO, and obviously represents the interest of the supermajority of directors that we have on the board who are independent.

Senator BENNETT. I want to make one more comment if I could, Mr. Chairman. There is a trend in industrial corporations, as opposed to the kinds of corporations you run, to move toward a chairman who is not the CEO. But it is not necessarily a chairman who is "disinterested." For example, Bill Gates is no longer the CEO of Microsoft, but you could not say that Bill Gates was not very much interested in every way in what goes on in Microsoft. The same thing is true, Andy Grove is the Chairman of Intel, but he is no longer the CEO of Intel. So the CEO is put in a position where he clearly is reporting to the board, and that I think is the important

issue here rather than whether or not the board chairman knows anything about the business, because there is always the fear if you get an independent chairman, he is so independent that he does not really understand. And in many ways my experience is you get such an independent chairman, you run the risk of increasing the possibility that the CEO can pull the wool over his eyes rather than decreasing it, because he is so independent he is divorced from the day-to-day operations and can be conned.

Nobody is going to con Bill Gates as to what is really going on in Microsoft or Andy Grove as to what is really going on in Intel. And I would think it might well be if the decision is made that it cannot be the CEO, it nonetheless must be somebody—can be, not must be, but nonetheless can be somebody who has a very big financial stake in the organization and a history of dealing with it. There is a kind of separation there between the chairmanship and the CEO that does not fit the legal definition of "disinterested," but might as a practical matter make a little more sense.

But having put that on the record, I will leave it up to the SEC to read the record. I am not necessarily looking for a response, but if you feel you have to, by all means.

Senator ARMSTRONG. Well, Mr. Chairman, the point you have made, which I agree with completely, illustrates——

Senator BENNETT. This is the Chairman [pointing to Chairman Shelby]. I am not.

Senator ARMSTRONG. I am sorry. Senator Bennett, the point you have made——

Senator SARBANES. We are very sensitive to that sort of thing. [Laughter.]

Senator ARMSTRONG. Yes, I understand that.

[Laughter.]

You are exactly right, but what that illustrates is precisely why it should be left to the boards of the 8,256 funds to make that decision. They will not all make the same decision based on a different set of circumstances. And if it is disclosed, it feels to me like that is a great outcome. Then investors can decide what they think the right answer is and they will have before them what the fund boards have decided as well.

Senator BENNETT. Thank you, Mr. Chairman.

Chairman SHELBY. Senator Carper.

COMMENTS OF SENATOR THOMAS R. CARPER

Senator CARPER. Thanks very much. I apologize for missing all of your testimonies. We have some interesting issues on the floor today, as you may know: Gun control legislation and assault weapons bans and gun show loopholes. I have been involved in some of that debate, and I apologize for missing what you had to say.

I would just like to start off by asking each of you what role, if any, do you believe that the Congress should play with respect to the governance issues that you are discussing and that we are discussing here this morning. I would be interested in hearing what your thoughts—not disinterested, but I would be interested in hearing what you have to say.

I want to say, that exchange between you and Senator Bennett a little bit earlier, Senator Armstrong, was just a classic.

[Laughter.]

I wish we could have videotaped that one and shown that one, say, at orientation for new Senators. It would have been good comic relief, and maybe instructive, too.

Mr. Miller, do you want to lead off?

Mr. MILLER. Sure. Senator, I believe that—we have discussed this a little bit this morning, and I believe that it makes very much sense for Congress, this Committee, to weigh in with their opinions, their judgments, express their policy concerns to the SEC or whatever agency might be involved. In this case, it is obviously the SEC that is more involved.

I do believe that the expertise, by and large, rests with the SEC. I believe that they take the pulse of Congress. I think that they are smart in that regard. But at the end of the day, probably because they have the expertise—this is what they do on a full-time basis and have been doing it for many years. I think because the industry tries to work in conjunction with the SEC to express our issues, our concerns, to express whether we oppose or favor, you know, there is a dialogue that goes on. And I think properly it is at the SEC level that there should be the rulemaking that governs the governance issues that we are here discussing this morning.

Senator CARPER. So if I understand what you are saying, you are saying our role is to really have our pulse taken and to share our sense with the regulators, at least in this instance, and to convey those beliefs.

Mr. MILLER. I certainly would think that Congress, this Committee, could make its role whatever it wanted to make its role. But I believe that probably from a prudent standpoint, from the standpoint of expertise and familiarity, deferring to some extent to the SEC, again, weighing in very much with your judgments and your opinions and expressing your beliefs, but looking to the SEC to set the rulemaking that governs the industry, including these corporate governance issues, would probably make sense.

Senator CARPER. Thank you.

Mr. Mann.

Mr. MANN. Well, I would say that I think there is significant risk for Congress to legislate details of corporate governance. That is what a board of directors is in place to do—to figure out what needs to be done in a given situation. I believe that most boards do what they should do.

That does not mean to say that you should not give lots of direction, gather lots of information, and try to influence the process. But it seems to me that legislation in this particular area would not be something that you should rush to do.

Senator CARPER. All right. Thanks.

Ms. Chang.

Ms. CHANG. Senator Carper, I agree that Congress should have a balance here in that having these hearings, you are hearing from the industry. What is very important here is to make sure that we restore investors' confidence and that there is appropriate governance. But as to the actual implementation, it should be left to the SEC. They have an excellent process. They listen to the industry. They give us time to comment. But the fund board uses their judgment, their experience, to be able to ask the right questions, follow-

up questions, challenging questions. And if there were legislation, I am concerned that it might take away the board's judgment and their use of the experience just in order to meet those laws.

So, I support leaving it up to the SEC, but with your direction and the fact that you have shown concern. By having these hearings, I think it has gotten front and center with respect to the SEC.

Senator CARPER. Thank you.

Mr. Armstrong, did you serve in the House of Representatives?

Senator ARMSTRONG. I did, indeed.

Senator CARPER. Did you ever serve in the U.S. Senate?

Senator ARMSTRONG. I did.

Senator CARPER. Well, I have always wondered: Is there life after politics?

[Laughter.]

Senator ARMSTRONG. Yes, sir, there is.

Senator CARPER. Is it pretty good?

Senator ARMSTRONG. It is not bad.

Senator SARBANES. That is very reassuring to all of us.

[Laughter.]

Senator CARPER. You are in an interesting position because you have sat in our seats, and maybe even served as a chairman. I do not know if you were independent.

Chairman SHELBY. He would be Chairman if he had stayed, but I am glad he left.

[Laughter.]

With all due respect to my friend.

Senator CARPER. Anyway, I think that we would have turned out okay. But you served here.

Senator ARMSTRONG. I did.

Senator CARPER. Now, you have an interesting perspective from within the industry. And just take a minute or two and using both of those hats, just tell me what you feel we should be doing here.

Senator ARMSTRONG. Thank you, Senator. In fact, I think the Committee is doing exactly what it should do. In light of the disclosures of wrongdoing by a handful, relatively speaking, of the 456,000 people that work in the mutual fund industry, a handful have stepped across the line and violated shareholder trust in an ethical or even in a legal manner. I do not think this Committee or the Senate would or should fail to take that seriously.

The hearings that this Committee is having, which are really a very ambitious schedule of hearings, are completely appropriate. And there may be some legislation needed. But it is my impression that the Securities and Exchange Commission has undertaken a very, very fast-track, ambitious schedule of reform proposals. I believe that this Committee will be generally well pleased with the outcome, and I think most of us in the industry are going to be pleased, at least with some of it. There will be some give and take as to whether the outcome is satisfactory. I am personally convinced that unless there are areas where we really need to clarify the authority of the SEC or where Congress wishes to give very specific direction that it thinks that the SEC needs, then I see no reason not to leave the responsibility with the SEC, but to make it clear that this Committee intends to hold the Commission fully

accountable for the outcome. But my impression is they are moving rapidly with a very ambitious agenda.

Senator CARPER. One last quick question, if I could. I am sure you have said this already earlier in your testimony before, but with respect to the proposed rules promulgated by the SEC, I think in January, as they pertain to independent chairmen, what were your views on that?

Senator ARMSTRONG. Senator, I am an independent chairman.

Senator CARPER. I thought so.

Senator ARMSTRONG. I am generally sympathetic to that idea, not only for mutual funds but actually for other kinds of boards. I am a director of several public corporations as well, at least one of which, partly because I lobbied for it, has an independent chairman. I think there are many times when that is a great idea. But I do not think it should be mandated by law or by regulation. I think that is a proper decision for the directors to make, and in turn, for shareholders to make. If a shareholder thinks that is a significant issue, then they can, in effect, vote with their feet. They can put their money in funds that have their preferred form of organization, but I think a one-size-fits-all approach is probably not a good answer.

Senator CARPER. Why does it work well for the fund for which you are the independent chairman? Why does it work well?

Senator ARMSTRONG. To have an independent chairman? Well, I am not sure that I was elected because I was independent. I was elected because my predecessor, who had been in the job 30 years, decided it was time to retire, and we could well have elected someone else who was not technically an independent director. But I am just convinced that these decisions generally are better left to each board to decide on a case-by-case basis.

I personally tend to favor independent directors, but I can certainly imagine situations, such as those that are represented at this table, where that is not the best answer in the shareholders' interests.

Senator CARPER. All right. Thanks. Thanks to all of you.

Chairman SHELBY. Senator Armstrong, just briefly, if you would, you serve as chairman of a mutual fund board. You are a director, of course. So how does this differ from serving on a public company board? You have done both and there is a difference, isn't there?

Senator ARMSTRONG. Oh, there is a tremendous difference.

Chairman SHELBY. Just briefly.

Senator ARMSTRONG. Mr. Chairman, the difference in brief is that a mutual fund board is an oversight responsibility. We do not run the company. A corporate board, for example, sets the salary of the CEO——

Chairman SHELBY. You serve on corporate boards.

Senator ARMSTRONG. I do serve on several corporate boards and have served on seven or eight public corporate boards at one time or another, where we set the salary of the CEO, the salary of individual corporate officers at the senior level, where we establish the budget, where we decide when to borrow money, where we decide what products to do, whether to merge or not—none of which are matters that properly come before a mutual fund board.

Chairman SHELBY. A mutual fund board.

Senator ARMSTRONG. A very different issue.

Chairman SHELBY. Mr. Miller, would you elaborate on how fund shareholders would be impacted by a ban on side-by-side management of hedge funds and mutual funds? Also if we were to ban side-by-side management of hedge funds and mutual funds, then would we also have to ban the simultaneous management of mutual funds and all other institutional accounts? I think there are unintended consequences here.

Mr. MILLER. Yes, Mr. Chairman, I would say that there are unintended consequences with that ban. I believe that if there were to be a ban of mutual fund and hedge fund management simultaneously, then at least consistency would suggest that there should be also a ban of ever managing multiple accounts involving multiple clients. I cannot see how that could work in the best interest of shareholders. I believe in my statement. I talked a lot about the fact that there is a relatively scarce commodity of really exceptional investment talent. I do believe mutual fund shareholders should have access to that talent, just like wealthy individuals or institutions. I believe 401(k) plan participants, who largely invest in mutual funds, should have access to that talent. And a ban, in my opinion, would clearly lead to at least some managers choosing the hedge fund over the mutual fund, in part because they can make more money running hedge funds.

Chairman SHELBY. Sure. What is the scope of the SEC's authority over portfolio managers who manage both hedge funds and mutual funds? Does the SEC have increased oversight authority over a hedge fund in a situation where a portfolio manager manages both of them?

Mr. MILLER. Hedge funds, Mr. Chairman, tend to be unregistered and, therefore, not per se subject to the SEC's jurisdiction. In the case of side-by-side management——

Chairman SHELBY. Well, Hedge funds are basically private, aren't they?

Mr. MILLER. Yes, sir. But in the case of side-by-side management involving a mutual fund, the SEC has access and jurisdiction because of that mutual fund management, and, therefore, because of that mutual fund management, have access and enforcement and inspection authority over the activities of the same person managing the hedge funds.

Chairman SHELBY. Would you quickly describe the fiduciary duties—I think this is important to the integrity of the mutual fund industry—that a board owes to the fund shareholders? Do you think that the current fiduciary standards are sufficient to protect investors? We will start with you, Senator Armstrong?

Senator ARMSTRONG. Yes, sir, I do. I personally think that they are extraordinarily high, properly so.

Chairman SHELBY. Ms. Chang.

Ms. CHANG. Yes, I agree. In fact, if I could come back to your question earlier of my colleague, Mr. Armstrong, with respect to the comparison of corporate boards, there are also a lot of similarities, and this also speaks to your question on fiduciary duties. Board members at both corporate level and at the mutual fund level—and I also serve on a corporate board—the quality of the board members who serve is very important. They must hold man-

agement accountable. They must look at the performance of the business, be it a corporate board or a mutual fund, and they must have an independent mind. They must be inquisitive.

The fiduciary duties, in terms of the standards, I believe are adequate, and I believe we have board members, both in the mutual fund industry and in the corporate world, who take their responsibilities very seriously.

Thank you, Mr. Chairman.

Chairman SHELBY. Mr. Mann.

Mr. MANN. I think the fiduciary standards are very high, and I think they are adequate.

Mr. MILLER. I would agree, Mr. Chairman. I think satisfying one's fiduciary duty requires the highest possible standard of care and fair dealing. I think those standards are adequate. They obviously need to be enforced.

Chairman SHELBY. But that is one of the challenges in the industry, maybe not with particular funds but with some funds today.

Mr. MILLER. I would say that is a fair statement, Mr. Chairman.

Chairman SHELBY. Mr. Miller, many contend that fund investors should receive more disclosure regarding the portfolio's manager compensation and fund holdings. How would this information benefit investors and how would it impact fund operations? I think this is being discussed up here, as you know.

Mr. MILLER. Vanguard is, generally as you know, Mr. Chairman, I believe in favor of additional disclosure. We think disclosure is good. I believe that when it comes to—if the proposal would be to actually disclose the dollar amount of the compensation of a portfolio manager or a senior executive of the fund complex, for that matter, that is not something Vanguard would favor. If there are proposals to disclose the structure of compensation, we believe that could make sense.

There is disclosure today of the fees that are paid to firms that manage money, and those fees should be properly disclosed, perhaps disclosed better than they are today. There is a difference, I think, between disclosure of the advisory fees paid to the firm and the particular compensation, dollar amount compensation of an individual. There we think that there is a common sense of privacy, just like we treat our shareholders and their information as private. It is a very serious commitment by Vanguard. In some respects you wonder what is the relevance to the investment decision to know what an individual is making. Someone mentioned earlier that could open up that individual to every headhunter out there. I think that would be a real concern. I think that basically——

Chairman SHELBY. That might not necessarily help the fund holders at all, right?

Mr. MILLER. I think that would not help the fund shareholders because you might then have that individual leave the management of mutual funds.

Chairman SHELBY. Senator Armstrong, you have a comment?

Senator ARMSTRONG. I think my colleague summed it up very well. Let us not put a bull's eye on the chest of these portfolio managers and send headhunters after them.

Chairman SHELBY. You agree, Ms. Chang?

Ms. CHANG. Yes, I do, and it also goes to the SEC's proposal where the board should determine the compensation of the compliance officer. I disagree there because the fund board hires outside contractors. An analogy is when I hire the audit firm, I do not require, nor do I set the salary of that partner. So, I would be more interested in the structure of the compensation.

Chairman SHELBY. Mr. Mann.

Mr. MANN. Mr. Chairman, I would like to make a comment about disclosure. One of my recommendations is that we should significantly improve the disclosure of fees and expenses. I think, to be very direct——

Chairman SHELBY. To the shareholders.

Mr. MANN. To the shareholders. To be very direct, I think that a confirmation statement should be given to the investor when an investment is made that spells out the mutual fund and brokerage fees and expenses in dollars and cents. Also in a quarterly or semiannual statement, the same thing, for each investment, what the expense is in dollars and cents and in percentage terms, so every investor can see what it is costing to manage their investments.

Chairman SHELBY. It should be done in unvarnished language too, should it not?

Mr. MANN. In just dollars and cents on their investment. The SEC has taken a step in that direction to show what the fees are per $1,000, but if you went through the details, what it would require an individual to really figure out how much money they are paying in expenses, it is very complicated and very difficult.

On your point specifically, I think it would be a drastic mistake to disclose the compensation of individual portfolio managers. I think perhaps disclosing the general structure of compensation could be worthwhile, and not even the details of that because that gives out information that would be a competitive problem.

Chairman SHELBY. This question has come up before here. Many people contend that fund directors are over committed and serve on too many boards. What are the considerations for determining the appropriate number of boards on which a director serves, and who should make that determination?

Senator Armstrong, I will start with you and then move over.

Senator ARMSTRONG. Interestingly, Mr. Chairman, when I was elected to be Chairman of the Mutual Fund Boards of which I am Chairman, that is one of the issues which was put to me by my colleagues before they voted to elect me, and what I told them was that if they chose to elect me, I would commit to shuck off anything that proved to be an impediment. I am busy. I have companies of my own to run, and I am a director of some other public companies. So, I think it varies with the individual, but clearly, anybody who is the chairman or a director of a mutual fund has to be prepared to devote the time and energy to do it. The right people to make that decision of whether that is happening are the other directors.

Chairman SHELBY. Ms. Chang.

Ms. CHANG. I do not know what the right number is, but I think there should be balance, and I agree with Mr. Armstrong in that it really depends on that individual's own time commitment as long as that individual is responsible, and they are doing their homework. I do not think the number of boards should be legislated.

As I mentioned in my oral comments, I can see the efficiencies and economies of scale of people sitting on multiple boards.

Chairman SHELBY. Mr. Mann.

Mr. MANN. I guess I would probably be able to speak to this as well as anyone. We oversee 292 mutual funds at Fidelity.

Chairman SHELBY. How much total money roughly?

Mr. MANN. Over $900 billion.

Chairman SHELBY. Getting toward $1 trillion.

Mr. MANN. Yes.

Chairman SHELBY. Vanguard is right behind you, right?

Mr. MANN. Yes, sir, they are.

[Laughter.]

Chairman SHELBY. Not on your back, but looking at you.

Mr. MANN. We are watching them closely.

Senator SARBANES. You are looking over your shoulder there.

Chairman SHELBY. Go ahead, Mr. Mann.

Mr. MANN. I would say this, that over the 10 years that I have been an independent trustee, the workload has increased dramatically, not just because of the number of funds that are overseen, but also because of a lot of other issues that have arisen over the last 2 or 3 years that have increased the amount of time that one must spend.

I would say to you that fortunately there is a lot of commonality of issues in overseeing mutual funds, and you focus on those one time if you are overseeing 10 funds or 100 or 200 funds, and then you have to review the individual funds. You review the funds, frequently on an exception basis, and then you have in-depth reviews periodically as required to make sure that things are going well, and that proper actions are taken.

Chairman SHELBY. Mr. Miller.

Mr. MILLER. Mr. Chairman, we have at Vanguard a common or a single board. We think that is highly appropriate. I will give you just briefly two reasons why: The commonality of the issues that cut across the various funds of the fund complex, and frankly, the consistency of the decisionmaking. It helps very much that these directors oversee all of the complex of the funds because you do get consistency in the way they look at the issues and they render their opinions and judgments.

Chairman SHELBY. Senator Sarbanes.

Senator SARBANES. Thank you, Mr. Chairman.

There is a line of thought that the standard for the fiduciary duties of the directors on these boards is inadequate in light of the Gartenberg decision in the Second Circuit in 1982. I am not going to take the time now to press you on that, but I would like you all to go back and look at that, and let us have the benefit of your comments. Just to take the example of trustees' fees, which after all the board is supposed to actively negotiate on behalf of its shareholders, this is what the Court said: "To be found excessive, the trustee's fee must be so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining."

That is a pretty low standard for a fiduciary duty in my judgment. I have some concern about that, and I know that all of you said that you thought the standard was appropriate, but I have dif-

ficulty drawing that conclusion looking at this language, the Second Circuit opinion for which the Supreme Court did not give cert 20 years ago.

Mr. Miller, I want to ask you about the hedge fund and the mutual funds, and having individual investment managers managing both. Now, I take it your position is that if you do not do that, you are going to lose a lot of talent because people will go off and do the hedge fund instead of the mutual fund. Is that right, that is one of the problems?

Mr. MILLER. That is part of the issue, Senator, yes.

Senator SARBANES. As I understand it, Vanguard does not manage hedge funds; is that right?

Mr. MILLER. Vanguard does not manage or offer hedge funds, but we do use, as I mentioned earlier, a number of outside investment advisory firms, some of which run mutual funds—hedge funds in addition to mutual funds.

Senator SARBANES. As I understand it, 70 percent of your assets are managed by your own people; is that correct?

Mr. MILLER. That is correct, sir.

Senator SARBANES. So, they are excluded from the hedge funds, is that right?

Mr. MILLER. We do not run hedge funds at Vanguard, so they do not run hedge funds.

Senator SARBANES. Do you feel you have a talent deficiency with respect to this 70 percent of the funds you manage, because you do not do hedge funds, and your people cannot do them? What are you saying about your own operation by your earlier testimony?

Mr. MILLER. Senator, I would make it very clear that we do not believe we have a talent deficiency at Vanguard. Frankly, we do not offer hedge funds. I am sure our people have the talent to do it, but we——

Senator SARBANES. I take it your position is that even not doing it, you can still get very good talent at Vanguard, right?

Mr. MILLER. We believe so, yes sir.

Senator SARBANES. Why do you then advance the general proposition that if people cannot do hedge funds and mutual funds you are not going to be able to get talent?

Mr. MILLER. What we are saying, Senator, is that at Vanguard we do not offer hedge funds because it does not fit our business model. You cannot offer—I have never seen one at least—a low-cost hedge fund. That is our business model. We have the talent in house to do hedge funds if we chose to do that. We just do not choose to do that.

We do believe that when you go outside to look for investment talent, it is a limited commodity, it is a scarce commodity, and to put people, individual managers of money in the position where they have to choose between a mutual fund or a hedge fund, we believe could lead to unintended consequences of those hedge fund managers deciding to pursue the hedge funds because, frankly, they can do different things from investment techniques and they can earn more money.

Senator SARBANES. Do you think hedge funds should be registered and that the SEC should move in to exercise more oversight over hedge funds?

Mr. MILLER. My position on that, Senator, would be to what purpose would you request to require the registration of hedge funds? I believe the SEC today has ample jurisdiction, depending on the circumstances of the particular money manager. For example, we have talked to you about side-by-side management, so again, if you have a person managing a mutual fund and a hedge fund simultaneously, the SEC has ample jurisdiction to go in to inspect and to enforce, to ensure that all clients are being treated fairly.

Senator SARBANES. What about the separate hedge fund?

Mr. MILLER. Some believe—and I am not an expert——

Senator SARBANES. Do you think it is a good thing, where it is side-by-side, that the SEC is able to do that with respect to the hedge fund?

Mr. MILLER. I think it does provide an additional degree of oversight and insurance, and perhaps comfort level that the SEC does have that ability to go in and look and enforce if there is side-by-side management of these funds.

Senator SARBANES. When there is not side-by-side management, why wouldn't the same argument apply with respect to the hedge fund alone?

Mr. MILLER. I think partly, Senator, it goes to the clientele of the hedge fund manager. In that circumstance, typically the clientele tends to be institutional money, very high net worth individual money——

Senator SARBANES. There is some concern that arrangements are now being set up that in effect allow what amounts to retail participation in hedge funds; is that not correct?

Mr. MILLER. There is some movement in that direction.

Senator SARBANES. What do you think about that? And if that is the case, what does it do to the proposition you just put to me? It makes it hollow and empty, does it not?

Mr. MILLER. I suspect, Senator, to the extent that the concern is retail—traditionally to find retail investors moving into hedge fund accounts because hedge fund managers are moving downstream, there would be some more legitimacy to the registration of hedge funds. In the typical model where hedge funds are doing the money management for the institutional and high net worth individuals, I think that is one of the reasons why there has not been registration required in the past.

Senator SARBANES. Thank you.

Chairman SHELBY. I want to thank the panel. It has been very informative, we appreciate your candor. Thank you all very much.

We are going to call up the second panel although we are on the verge of having three stacked votes on the Senate floor.

Ms. Ann Bergin, Managing Director of the National Securities Clearing Corporation; Mr. William Bridy, President, Financial Data Services, Inc., a subsidiary of Merrill Lynch; he will testify on behalf of the Securities Industry Association, SIA; Mr. Raymond McCulloch, Executive Vice President, BB&T Trust, testifying on behalf of the American Bankers Association; and Mr. David Wray, President, Profit Sharing/401(k) Council of America.

We welcome our second panel and we appreciate your patience here this morning in waiting for the first panel, which has been

more than interesting. All of your written testimony will be made part of the Banking Committee's hearing record in its entirety.

We will start with Ms. Bergin. If you will sum up your testimony, we will go from here. Thank you, Ms. Bergin.

STATEMENT OF ANN E. BERGIN
MANAGING DIRECTOR
NATIONAL SECURITIES CLEARING CORPORATION

Ms. BERGIN. Chairman Shelby, I appreciate the opportunity to discuss the recent SEC's proposal to amend Rule 22(c)(1) of the Investment Company Act of 1940. With your permission, I would like to have two documents previously provided to Committee staff, included in the record.

Chairman SHELBY. Without objection, it will be made part of the hearing record.

Ms. BERGIN. Thank you. The February 6, comment letter to the SEC on the proposed amendment, and a brochure that describes how Fund/SERV, which is our fund processing system, works.

NSCC and its affiliated clearing agencies play a significant role in supporting the U.S. financial markets. We provide post trade clearance, settlement and information services, not only for mutual funds, but for equities, fixed income and other securities as well.

I have been asked today to speak about one aspect of the SEC's proposal which provides that in order to purchase or redeem shares in a mutual fund, it be received by the fund, its transfer agent or a registered clearing agency prior to 4 p.m. in order to receive the current day's price.

NSCC is currently the only registered clearing agency providing services to the mutual fund industry. We are registered with the SEC and subject to comprehensive regulation and oversight by the Commission. As such, our Fund/SERV system was directly reference in the rule proposal. NSCC is owned and governed by our users. Our revenues are generated by the fees paid by our users and excess revenues are refunded to them.

Our participation in the mutual fund industry began in 1986 at the request of market participants looking for a way to address market inefficiencies. Our Fund/SERV system provides a central automated process for broker-dealers and other distribution intermediaries to transmit purchase, redemption and exchange orders through a single standard process and communications link. Like all of our fund services, participation in Fund/SERV is optional, but it has become the industry standard for processing fund and defined contribution transactions at the wholesale level.

We estimate today that Fund/SERV processes the vast majority of these wholesale transactions. Last year Fund/SERV handled 87 million fund transactions, roughly 350,000 on the average day. Fund/SERV is used by——

Chairman SHELBY. How many on the average day?

Ms. BERGIN. On the average day 350,000. Fund/SERV is used by about 650 mutual fund companies, offering 30,000 different funds and more than 430 distribution intermediaries. Fund/SERV has had a tremendous impact on the efficiency of the industry over the years by greatly reducing operational errors and processing costs. It has established broadly adopted standards and introduced order

into the marketplace. By acting as a central conduit, Fund/SERV allows intermediaries to offer a much broader range of funds than before at a much lower cost.

Under current regulation, as long as a broker-dealer is in receipt of a mutual fund order by 4 p.m., the order is given that day's closing price regardless of what time the trade is processed through Fund/SERV, which today could be up until midnight or in some circumstances the following morning. Under the proposed regulation, even if the order is received by the broker-dealer before 4 p.m., unless it is transmitted to the NSCC, the fund or its transfer agent by 4 p.m., the purchase would not be made at that day's price.

Although we anticipate that this would dramatically change the current trade flow and result in a significant increase in the number of trades received at NSCC in the half hour just prior to 4 p.m., we believe our current system's capacity is sufficient to handle a concentration of orders in that time frame. However, we will need to make some enhancements to our services. To date we have identified three.

First, we would need to create a uniform methodology to record the time of receipt of each file and each order within that file before transmission to the fund. Second, our system would need to recognize the elements of a complete and valid order so that the order is final and unalterable as of 4 p.m. Those elements would include the name of the fund, the specific number of shares or dollar amount of the trade and whether the order is a purchase, redemption, or exchange. Third, we would need to build functionality to allow intermediaries to communicate additional information about a valid order after 4 p.m. An example of that would be breakpoint discounts to which a shareholder would be entitled, as long as the information would not alter any of the essential elements of the order.

We believe we can complete these enhancements within the 1 year following adoption of the amendment as was proposed by the SEC at an estimated cost of approximately $5 million, which as I indicated earlier, would be funded by our users. It does not include costs that would be incurred by our users in making conforming changes to their own systems.

We do recognize that migrating the time-stamping function from the intermediary to NSCC will impose some limitations on the flexibility that fund investors currently have. We feel very strongly, however, that applying a hard 4 o'clock close at NSCC is far better for investors than applying that close at the fund or the transfer agent.

The SEC, in their proposal, offered an alternative solution which would leave the responsibility for time-stamping at the intermediary level with the adoption of new safeguards to prevent late-trading abuses. In our comment letter to the SEC, we advised that implementing this alternative would preserve the flexibility of the current system. Whatever the Commission's final determination, NSCC is committed to working with the industry to facilitate compliance with the new regulations.

That would complete my prepared remarks.

Chairman SHELBY. Thank you.

Mr. Bridy.

STATEMENT OF WILLIAM A. BRIDY
PRESIDENT, FINANCIAL DATA SERVICES, INC.
ON BEHALF OF THE
SECURITIES INDUSTRY ASSOCIATION

Mr. BRIDY. Good morning and thank you very much, Chairman Shelby, Ranking Member Sarbanes, and Members of the Banking Committee.

I am Bill Bridy. I am President of Financial Data Services, Inc., a wholly-owned subsidiary of Merrill Lynch. My business unit is responsible for the prompt and accurate processing of mutual fund orders placed through our firm. I am honored to appear before the Committee today on behalf of the Securities Industry Association, and I commend the Committee for your many contributions to the efforts to protect investors.

We agree that the practice of late trading is unequivocally illegal, and its very existence threatens to undermine the public's trust and confidence in mutual funds. For this reason we applaud the strong enforcement actions the SEC and other authorities are taking to punish wrongdoers.

My testimony today will focus on the "hard close" solution at the intermediary level. The intermediary level includes broker-dealers, banks, trust companies, insurance companies, and third-party administrators supporting the 401(k) marketplace. Such a solution will entitle the mutual fund orders to receive current day pricing as long as the order is received by a broker-dealer or other intermediary by the time the subject mutual fund determines its net asset value or NAV, which is generally 4 p.m. Eastern Time.

This solution would benefit 88 percent of the 95 million investors in mutual funds. The solution is predicated on two core principles. The first, that a critical factor is not where an order is physically located at the time a fund's net asset value is determined, but rather whether the receipt of such time can be verified with a high degree of certainty. Second, and most importantly, the available hard close solution must not be detrimental to or in any way disadvantage the tens of millions of honest mutual fund shareholders who are not trying to game the system.

The Securities and Exchange Commission recently made a proposal that would essentially allow for hard close solutions only at the fund or the registered clearing agency level. In the proposing release, the Securities and Exchange Commission recognize that requiring a hard close at the fund level would require that intermediaries establish an earlier preclose cutoff time for investors to submit fund orders and obtain current day pricing with respect to 401(k) plans. The SEC acknowledged that investors may not be able to receive same-day pricing at all.

The net result of the earlier cutoff time is that the vast majority of fund shareholders who deal through intermediaries, some 88 percent of fund share investors, would be unavailable to effect fund purchases at current day prices for at least a portion, and possibly the entirety, of the trading day. The hard close at the fund remedy also fails to provide for an effective tamper-proof electronic order capture time-stamping system. The proposed remedy merely carries over the current time-stamping requirement, which is shown to be prone to abuse both at the fund and the intermediary levels.

We advocate adoption of the Securities Industry Association's electronic order capture time-stamping approach for funds, brokers and 401(k) intermediaries to cure the shortcomings. The Securities Industry Association's hard close of the intermediary solution would require broker-dealers to use an electronic order capture and routing system, which assigns a verifiable order entry time aligned with the atomic clock currently used for equity order time-stamping. Other regulated and nonregulated entities would have to use a system certified to be functionally equivalent. It is noteworthy that House bill H.R. 2420 and several of the bills introduced in the Senate propose a similar approach.

Importantly, the SIA recommendation contemplates that orders not accepted into the intermediary system by the hard close, even where the lack of timely receipt was due to legitimate errors, would, without exception, receive next-day pricing. Thus, corrections would have to be effected through an error account and essentially they, not the fund shareholders, would bear the economic risk of loss with respect to any orders processed after the hard close.

So the Securities Industry Association's proposal would impose stringent additional requirements on the use of time-stamping methodologies that would make it extremely difficult to game the system. And the Securities Industry Association recommendation, which could be implemented expeditiously, would eliminate the inadequacies of the current time-stamping system and would create a readily auditable order trail, while avoiding the significant adverse consequences of early order cut-off times. Electronic and auditable electronic time-stamping systems are critical components to any effective hard close rulemaking solution. This approach would place the vast majority of investors holding their fund investments through intermediaries on a more level playing field with other investors.

While imposing a hard close at the fund or registered securities clearing agency should be among the available alternatives, these measures should not be the exclusive solution.

We are really looking forward to working with your Committee to swiftly and effectively eliminate late trading in a way that protects all investors and does not create competitive advantages for some. We believe such measures are essential to maintaining the integrity of our capital markets and retaining the public trust of the 95 million Americans for whom mutual funds are a core investment vehicle.

Thank you.

Chairman SHELBY. Thank you. We are going to recess the hearing. We have the first vote coming up immediately. We will recess for about 30 minutes. If you will stick around, we will get on with the rest of the panel.

[Recess from 11:49 a.m. to 12:36 p.m.]

Chairman SHELBY. The hearing will come to order.

I know that was a long 30 minutes, but that is in the tradition of the Senate and the way it is managed. I apologize, but this is the way we operate up here as you well know.

Mr. McCulloch, you proceed.

STATEMENT OF RAYMOND K. McCULLOCH EXECUTIVE VICE PRESIDENT, BB&T TRUST ON BEHALF OF THE AMERICAN BANKERS ASSOCIATION

Mr. MCCULLOCH. Thank you, Mr. Chairman.

I am Ray McCulloch. I am the Executive Vice President for BB&T Trust. I have over 26 years of banking experience with the last 12 focused on trusts and employee benefits.

BB&T Trust administers over 2,200 employee benefit plans with total assets equaling $5.2 billion. Our parent, BB&T Corporation, is the Nation's 13th largest bank, and I am pleased to testify on behalf of the American Bankers Association.

As investors and intermediaries of mutual funds, ABA members are quite concerned about the issue of late trading. Let me be very clear. ABA members emphatically believe that late trading has no place in mutual funds. This practice is illegal under current law, and we applaud the SEC for punishing those at fault.

The SEC's proposal, however, often referred to as the 4 o'clock hard close, is unworkable and will have a detrimental effect on investors, particularly the millions of people who have trusted their retirement and trust accounts to banks like mine to manage. While the SEC's proposal seems to be a simple solution to the problem of late trading in practice, it would result in different cut-off times for mutual fund companies and for intermediaries that sell shares of funds of those companies.

This occurs because the processing, particularly for 401(k) plans is operationally complex and time consuming. Unlike the mutual fund companies that can perform all the processing tasks after 4 o'clock, all other providers must complete the processing before 4 o'clock. Processing trade orders involves as many as five steps using four separate systems, as discussed in my written statement.

For BB&T Trust it generally takes 3 hours to complete the processing. For other ABA member banks, it can take much longer. This would mean that an investor making a decision at 3 p.m. would get today's price if he or she dealt with the mutual fund directly, but tomorrow's price if the order was placed through us. It makes no sense for the SEC to create a system that discriminates against investors based upon the choice of one distribution channel over another.

Fortunately, alternatives to the SEC's proposal exist. The key is a tamper proof order system where the entry time of an order can be verified with a high degree of certainty. This would allow fund intermediaries to receive orders up to the time of the net asset value calculation. The time-stamping, whether done by an outside company or internally, must be subject to audit. Annual audit of controls and certification of policies and procedures would be appropriate. Time-stamping processes are already available, and companies are working to make the electronic signing of documents, using digital certification, as simple as signing a piece of paper with a pen.

And technological solutions can be expensive to implement. Thus, it is very important that the SEC's approach be flexible and sensitive to the cost and provide an implementation period of at least 1 year.

Finally, Mr. Chairman, the ABA appreciates efforts by Senators to assure that solutions to late trading do not disadvantage investors. We are hopeful that, with your strong encouragement, the final SEC regulations will recognize this as well. Should it not, it may become necessary to address this through legislation.

Thank you for the opportunity to present the views of the ABA.

Chairman SHELBY. Thank you.

Mr. Wray.

STATEMENT OF DAVID L. WRAY
PRESIDENT, PROFIT SHARING/401K
COUNCIL OF AMERICA
ON BEHALF OF
ASPA, ASSOCIATION FOR FINANCIAL PROFESSIONALS, AUTOMATIC DATA PROCESSING, INC., COMMITTEE ON INVESTMENT OF EMPLOYEE BENEFIT ASSETS, THE ERISA INDUSTRY COMMITTEE, FLINT INK CORPORATION, FLORIDA POWER & LIGHT COMPANY, HEWITT ASSOCIATES, ICMA RETIREMENT CORPORATION, INTEL CORPORATION, PROCTER & GAMBLE, PROFIT SHARING/401K COUNCIL OF AMERICA, SMALL BUSINESS COUNCIL OF AMERICA, AND SUNGARD CORBEL

Mr. WRAY. Good afternoon, Mr. Chairman. I am David Wray, President of the Profit Sharing/401K Council of America, an association of employers that provide profit sharing and 401(k) plans for their workers.

Thank you for this opportunity to share the views of the employer-provided retirement plan system with the Committee. My comments reflect the views of the companies and of the organizations listed on the transcript of my statement.

As we all know, mutual funds play a key role in the employer-based system. According to Investment Company Institute, 36 million U.S. households invest one-third of all mutual fund assets through employer-provided retirement plans. Like this Committee, we are concerned by the breaches of trust that have occurred recently, and we applaud the efforts under way in the Congress to restore confidence in our Nation's financial institutions.

Late trading must be eliminated. At the same time it is important that we preserve a level playing field for the ability to make investment decisions using same-day pricing. In most employer-provided plans, investors can make trading decisions up to or very close to a fund's closing time, generally, 4 p.m. Eastern Time. Some have questioned if plan participants value same-day pricing. I can assure you that they do, as evidenced by the predominance of this feature in 401(k) plans. Like all investors, plan participants adopt a long-term saving strategy, and only infrequently make changes in their investment decisions. However, when plan participants do make investment change decisions, they highly value same-day pricing. This is particularly true for distribution decisions upon retirement.

Same-day pricing in employer-provided retirement plans is possible because intermediaries are permitted to process participant trades and forward the final aggregated trades to the funds or a clearing agency after 4 p.m. This late processing is necessary to

ensure that all the requirements surrounding the operation of a qualified retirement plan are met, including satisfying plan features and the highly complex rules issued by the Departments of Labor and Treasury. On a more basic level, fund trade processing is always delayed to reflect the fund's net asset value for the current day, an event that does not occur until well after 4 p.m.

Congress understands the need to preserve same-day pricing in employer-provided plans when addressing late trading. The House overwhelmingly passed H.R. 2420 last November. It instructs the SEC to issue rules to address late-day trading that permit late processing by retirement plan and other intermediaries if procedures exist to prevent late trading and such procedures are subject to independent audit. Similar provisions are found in S. 1971, cosponsored by Senators Corzine, Dodd, and Lieberman; and S. 2059, cosponsored by Senators Fitzgerald, Levin, and Collins. I applaud these Members for all of their efforts, and I urge this Committee to move forward on this important legislative provision if the final SEC rule on late trading fails to preserve equal opportunities for all investors.

Under the SEC's proposed rule, to offer same-day pricing an order must be received by the fund, its designated transfer agent or a registered securities clearing agency by the fund's closing time. This means that a retirement plan participant's ability to enjoy full same-day pricing will be based on the employer's selection of a plan intermediary and investment choices. Employers will be pressured to adopt service provider arrangements that favor same-day pricing over an open architecture design with offerings from several fund complexes. Participants could be influenced to invest in proprietary funds of the intermediary when also offered funds from other fund complexes. Intermediaries will incur significant initial and recurring systems cost that will be borne by participants.

I commend Ann Bergin and the NSSC staff for their valiant efforts to develop a viable process to meet the SEC's clearing agency proposal. Although the clearing agency approach will provide some relief to retirement plan participants that do not trade in a bundled provider environment, it will not create parity among investors. It will not accommodate all plan transactions, and it will result in additional costs for many plan participants.

There is a preferable way to address late trading. The SEC has requested comments on an alternative approach. And this would include tamperproof time-stamping, certification policies, and independent audits. This approach is very similar to that in the legislation I mentioned earlier in my comments. A large majority of SEC commenters, including leading consumer organizations support inclusion of this approach in their final rule. Several technology companies have confirmed their ability to provide the technological safeguards sought by the SEC.

I hope that the SEC final rule will include this alternative approach that preserves the opportunity for same-day pricing for all retirement plan participants. I repeat my request for this Committee to intercede legislatively if that does not occur.

Thank you very much for this opportunity. I look forward to your questions.

Chairman SHELBY. The goal of the “Hard 4 p.m. Close” is to stop illegal late trading. Without a hard 4 p.m. on order delivery to the funds, how do we ensure that the late trading window has been shut? Are there solutions—you alluded to something—that can be immediately implemented that address the problem? Ms. Bergin, we will start with you.

Ms. BERGIN. I think, Chairman, there are probably several solutions that could be workable. The question is: At what point can we certify or determine that a shareholder’s intent to make a trade is determined prior to 4 p.m. Today that determination is made at the intermediary level, and for the most part, I would say, is preserved there, even though the processing happens after 4 p.m.

I think that the SEC is certainly looking for some greater validation of that going forward and has suggested several alternatives, though they do still preserve the opportunity for the intermediary.

Chairman SHELBY. Could you describe the technology that would be needed to support the NSSC’s proposal? Is the technology currently available? If not, how long would it take to develop and to implement a new system?

Ms. BERGIN. Some of that technology is available. It would require additional technology to actually stamp a file that contains trades, and stamp each of those trades within that file, and transmit that information.

We have estimated that it would take us the better part of the year that the SEC has proposed.

Chairman SHELBY. All that will be subject to audit, of course, would it not?

Ms. BERGIN. Exactly, yes.

Chairman SHELBY. Are you talking about maybe software of a year or so ahead or what?

Ms. BERGIN. It would take about a year to develop and implement that, yes.

Chairman SHELBY. Mr. Bridy, many contend that in place of the “Hard 4 p.m. Close,” the industry could implement an audit trail and time-stamping system at the intermediate level. How would a system work like that? How will you authenticate a mutual fund transaction and prevent people from altering records? This is important to have an auditing trail that would be hard to alter.

Mr. BRIDY. Within the broker-dealer community, there is a platform today that we use for equities which is referred to as OATS. That provides a hard and a verifiable time-stamp on every single security.

Within our firm, being Merrill Lynch, we have a hard clock, and you cannot enter a trade after 4 o’clock for that day’s execution. If so, our system will automatically process that trade entered after 4 p.m. on the next day for execution. Also, not only is our retail broker-dealer business within the broker-dealer entity, but also our 401(k) business is within the construct of the broker-dealer. Both of our trading platforms have the capability to ensure that a hard clock is implemented within the structure of the broker-dealer intermediary.

I think what is critical is that there are technologies that exist today that can ensure a hard close is implemented at the intermediary level. The need to transmit a transaction to either the

fund or to a clearing organization prior to 4 p.m., in effect, in our view, will substantially disadvantage about 88 percent of the fund investor marketplace. Eighty-eight percent of the marketplace conducts their business through an intermediary today. So how do we sit there and say we are going to disadvantage 88 percent of the marketplace because of the channel they use to execute a trade?

Chairman SHELBY. Sure. Mr. McCulloch, go ahead and compare how you currently monitor late trading with how you would do it under your proposal. Why should the regulators have confidence that your proposal will be accurate? How do you ensure the integrity of the information which goes to the crux of it?

Mr. MCCULLOCH. Today, we cannot accept post-4 o'clock trading on our current systems. I, like my colleague from Merrill, have systems that shut down and flip to the next day automatically.

What we do not have today that would make the audit trail much easier for our internal auditors, external auditors, and the FDIC and Fed to come in and check would be the electronic stamping. Knowing that this was coming, we have already had discussions with our software provider about this technology so that we can—as the 1-year time frame has been put forward, would give us time to put that in. Then if, in fact, my customers, being those participants out in the country and their employers, call me—as some have already done—and ask me at BB&T, "How are you protecting this from happening?" Not only can I tell them that my current systems will stop it, but I can also turn to them and say that my regulators and my auditors now can follow my pattern of behavior electronically.

Chairman SHELBY. Okay.

Mr. Wray, would you elaborate on your concerns with the NSCC's proposal? Why doesn't the designation of the NSCC as a national clearinghouse work for the plan administrators?

Mr. WRAY. The regulatory compliance requirements of 401(k) plans are much more complicated than a typical order processing. For example, for a plan loan, you can only borrow up to 50 percent of your account balance, and that does require a transaction if you request a plan loan. You have to know the NAV in order to run the test to make sure that the person has not asked to withdraw more than 50 percent of their account balance. And so you have to hold back that processing until you get this other information. That is an example, and there are a lot of cases like that.

So the special compliance requirements that are imposed on the 401(k) system really make it impossible to utilize that kind of process. The people that we——

Chairman SHELBY. Is it too simple for 401(k)s?

Mr. WRAY. Pardon?

Chairman SHELBY. Is that process too simple for 401(k)s?

Mr. WRAY. Right. We have talked to the recordkeepers that we work with, and they say that they would have to impose a cutoff approximately 4 hours earlier in order to run all their evaluations and things, and then they could get it over by 4 o'clock to the clearing agency. But they could not still provide equivalent treatment compared to a 401(k) participant who is in a bundled investment product who can still trade right up to 4 o'clock, because the direct relationship with a mutual fund permits that in that case.

So what we are trying to do is have a level playing field. We do not want to see plan sponsors and participants making plan design decisions or investment decisions based on how processing works or trade handling works. It should be based on other things.

Chairman SHELBY. Basically it is your concern that the proposal to have the NSCC serve as a clearinghouse for trades does not take into account all the trades made by the 401(k) participants. Is that correct?

Mr. WRAY. That is correct.

Chairman SHELBY. And, of course, we have a challenge of how to resolve the problem, right?

Mr. WRAY. Correct. We are with the other members of the panel.

Chairman SHELBY. Sure.

Mr. WRAY. If you look at the 401(k) system, nowhere in the 401(k) system is there any evidence or even allegation that there was any wrongdoing in this area. And it is a huge system.

Chairman SHELBY. So how much money, roughly, is invested through the 401(k) system?

Mr. WRAY. Probably, if you include all of the 401(k) products, such as 403(b)'s, it is probably $2 trillion.

Chairman SHELBY. Two trillion dollars.

Mr. WRAY. Right.

Chairman SHELBY. That is not pocket change.

Mr. WRAY. No, it is not. And there is no allegation that there was any wrongdoing in the system, and yet we are imposing a solution or talking about a solution that would harm this innocent group of people.

Chairman SHELBY. But we have to protect, see what we can do, and the SEC has to see what they can do to protect the whole shed and everything under it.

Mr. Wray, some contend that the "Hard 4 p.m. Close"—we keep talking about that—is not a real hardship for 401(k) investors because they are long-term investors. How would you respond to the assertion that 1 day's price really does not matter for 401(k) investors because they are in it for the long haul?

Mr. WRAY. Well, there is no question that 401(k) participants do not trade their accounts.

Chairman SHELBY. I know.

Mr. WRAY. I mean in the normal cases. But they do make transactions that are very important, and I will use an example.

Chairman SHELBY. Sure.

Mr. WRAY. In 1987, on Friday afternoon, there was an anticipation that the market would do certain things, and on Monday, the market lost 25 percent of its account value. If I am in the process of converting my assets from equity assets to fixed assets in order to buy an annuity when I retire——

Chairman SHELBY. What if you went to cash?

Mr. WRAY. But you have to sell to go to cash.

Chairman SHELBY. I know.

Mr. WRAY. Then you convert the cash to an annuity. I mean, this person needs to have a high degree of certainty.

Chairman SHELBY. The market was going to drop 25 percent. You better do something, shouldn't you?

Mr. WRAY. Right. And you want some degree of certainty. Kicking the trade over to the end of the next day, who knows what might happen between that decision and the next. We need the highest degree of precision and predictability that we can get. That is the reason the system is moving to daily evaluation. This is how the system should work.

So it is very important in those cases when the employee does make changes in their account balance.

Chairman SHELBY. Ms. Bergin, do you want to comment on that? Do you have any comment?

Ms. BERGIN. I would comment insofar as NSCC does acknowledge that the 401(k) market is significantly more complex than the retail market.

Chairman SHELBY. Than ordinary transactions.

Ms. BERGIN. Absolutely. We have worked with many of our clients who are 401(k) recordkeepers, and we have carved out——

Chairman SHELBY. Well, how do we work it out?

Ms. BERGIN. I am sorry?

Chairman SHELBY. How do we work it out?

Ms. BERGIN. I think, Mr. Chairman, some of the transactions——

Chairman SHELBY. Or how does the SEC work it out?

Ms. BERGIN. Our system would recognize the transaction coming through as a retail—it looks to us like a retail trade in the new 4 o'clock world. There are some certain transactions that the trade record could not be built at the recordkeeper until after the NAV is known at 4 p.m. So unless there is a carveout for those kinds of transactions——

Chairman SHELBY. What is the harm here? There has to be a downside to something here. What is the uptick and what is the downside? Obviously, Mr. Wray is concerned about certain things.

Ms. BERGIN. I think I would share his concern for the 401(k) investor, that he is going to have less ability to move his money in the same way a retail investor would, you know, on that same-day time frame.

Chairman SHELBY. But how do we resolve it?

Mr. McCulloch.

Mr. MCCULLOCH. I would like to make two points.

First of all, I go back a long way in this business and remember the days of common trust funds where you could only submit transactions quarterly. And the business has evolved really to a 24/7 environment where you can do things through Internet and voice response. If we move backward from that, our investors not only will be harmed, but they also will be terribly disappointed they do not have prompt access.

We are in a very regulated business as a bank. We have multiple regulators in our shop. To have them look at our policies, our procedures, and our audit trail and have that certified annually, I am more than happy to do that if that solves the problem the SEC has concern about, that we at BB&T and other banks we are not processing past 4 o'clock.

The technology exists today to do that, and to me it is common sense that we would take that approach to ensure that when I am selling these services and supporting these services that I, in fact, am living within the law.

Chairman SHELBY. Mr. Bridy.

Mr. BRIDY. I think there is one other thing we want to mention. Not only do we have a problem in the 401(k) arena, but we also have problems in the retail arena, because intermediaries are going to have to back up their closing process to calculate trades and distribute those trades. A lot of trades are linked trades where you are selling one security and purchasing with the proceeds from another and you need pricing for execution. So, we would have challenges within that arena.

I think that the other significant disadvantage is that the whole world does not reside on the East Coast, so if we are going to start backing things up and we are going to close off retail at 2 o'clock, well, then we are going to be shutting down the West Coast at 11 o'clock in the morning, and it becomes even more exaggerated as one moves west.

Chairman SHELBY. Four o'clock Eastern Time might have worked at one time, or seemingly so, but with the 24/7 investment syndrome, worldwide, internationally, we have challenges. Isn't that what your message is?

Mr. MCCULLOCH. Exactly. But, again, getting back to audit and verification, we are more than willing to do that to ensure our investors that we are not processing past 4 o'clock. We hire external auditors. We have the FDIC audit. We have DOL. There are enough bodies to oversee this, but obviously not to raise the cost dramatically. Electronically, we could provide that information, as an intermediary.

Chairman SHELBY. Well, we have a lot of work to do. We have a number of hearings left on the mutual fund industry, where we will be looking at it.

We appreciate your patience today and appreciate your input for the record. Thank you so much. It is getting late in the day. The hearing is adjourned.

[Whereupon, at 1:02 p.m., the hearing was adjourned.]

[Prepared statements supplied for the record follow:]

PREPARED STATEMENT OF SENATOR WAYNE ALLARD

Thank you, Chairman Shelby, for holding this hearing to discuss the operations and governance of mutual funds. This is the fifth hearing the Committee has convened to discuss mutual funds, and I feel that we have gained a great deal of knowledge. I appreciate your special attention to this matter as revelations of late trading and market timing abuses have signaled the need for closer scrutiny of the mutual fund industry. In particular, I appreciate the balanced and cautious approach you have taken in examining such a critical part of the U.S. economy.

Mutual funds are a unique investment vehicle, allowing middle-income Americans the ability to invest responsibly and save for the future. While many invest in mutual funds to save for college or a house, much of the saving by Americans is done in retirement accounts and 401(k) plans. Whatever the ultimate reason for investing in mutual funds, Americans deserve to be confident about the decisions they are making. Congress plays a critical role in seeing that the necessary steps are taken so that investors remain confident, and the industry remains vibrant.

The late-trading and market-timing abuses that have been brought to light are disturbing, and those who are guilty of these wrongdoings must be punished. However, as we move forward in examining the mutual fund industry and its investors, it is essential that we are as prudent and as deliberative as necessary. As Congress, it is our job to ensure that existing law is vigorously enforced. Furthermore, we must see to it that we do not overreach our authority.

Today, we will discuss how funds actually operate, and who is involved in that process. I am pleased to welcome my good friend and colleague, Senator Armstrong, to the Committee today. Senator Armstrong is no stranger to this room as he served on this very Committee, as well as the Senate Finance and Budget Committees. He is currently the Independent Chairman of Oppenheimer Funds, and serves as a Director of Helmerich & Payne—a leading oil and gas-drilling contractor, and UNUM Provident—the world's leading disability insurer. His extensive understanding of the legislative process coupled with his experience in fund governance will undoubtedly provide the Committee with valuable insight and wisdom in our examination of fund operations and governance. Welcome, Senator.

I would also like to welcome the other witnesses to the Committee today. You all have very busy lives and we appreciate you taking the time to come and share your experience and expertise with us. I look forward to your testimony.

PREPARED STATEMENT OF WILLIAM L. ARMSTRONG

INDEPENDENT MUTUAL FUND DIRECTOR & CHAIRMAN, OPPENHEIMER FUNDS
FORMER U.S. SENATOR (1979–1991)

MARCH 2, 2004

Mr. Chairman and Members of the Committee, thank you for the opportunity to appear before you this morning. I am an Independent Mutual Fund Director and Chairman of the Denver-based Oppenheimer Funds. Our 38 funds manage $75 billion for 5 million shareholder accounts.

During the past few months, my colleagues and I on these fund boards have learned with mounting indignation that some mutual fund industry executives have violated the trust placed in them by shareholders. In my opinion, *we should throw the book at those who have done so.*

But let's keep one thing in mind—the wrongdoing has been discovered—and can be readily punished—under the existing statutes and regulations. *Nothing has happened which calls for sweeping new legislation.*

The fund industry is already heavily regulated. So, I urge Senators to go slow in considering costly and burdensome new requirements and regulations that could end up costing shareholders more than the abuses they are intended to correct. If that were to happen, it would be tantamount to *punishing the victims instead of the violators,* punishing shareholders instead of those who betrayed them.

Does this mean Congress should do nothing?

Absolutely not. I have reviewed *106 specific proposals* contained in pending legislation and regulations. All are undoubtedly well-intended. And some, particularly recommendations for enhanced disclosure, are highly desirable. I recommend such measures for your approval.

But other proposals do not take into account the unique nature of funds and the role of mutual fund directors. In contrast with corporate directors, our role is one of oversight. The adviser created the fund, and investors have chosen to invest in

it. Fund investors do not expect or want us to take control of the fund, nor be deeply involved in day-to-day management, as would become inevitable under some of the pending proposals.

Based on my experience as an independent fund Director, I believe Congress should evaluate proposed legislation based on the following considerations:

1. More than *54 million American families* own mutual funds in 95 million accounts. These shareholders are invested in eight thousand funds with assets totaling approximately *$7 trillion.*

2. Mutual funds have been and continue to be a *powerful engine for economic growth and wealth creation for American families.*

3. Mutual funds are the primary investment vehicle for *middle- and low-income families.* Wealthy investors have access to many different kinds of investments and a wide range of financial advice. But for most families, mutual funds provide skilled, professional investment management that would not otherwise be readily available to them *or would be available only at a significantly higher cost.*

4. Although instances of misconduct by people managing or dealing with mutual funds have been widely publicized, recent sensational news reports should not obscure the tradition of honorable dealing and high ethical standards for which the industry has long been recognized. Almost all of the *456 thousand men and women who work in the mutual fund industry are decent, hard working, and honorable.* They have served shareholders with dedication and expertise.

5. *The mutual fund industry is already heavily regulated.*

6. Proposed reforms should be carefully vetted to *weigh costs against benefits and to avoid unintended consequences.* Although I do not know the extent of investor losses as a result of misconduct by these wrongdoers, various estimates run from tens to hundreds of millions of dollars.

Nor do I know the exact cost to shareholders of pending legislation, but some news articles have estimated that cost at more than $1 billion in one report, and 5 to 10 basis points (a basis point is 1⁄100th of 1 percent) of the total assets in another article. I cannot vouch for these numbers, but my experience as Chairman or Director of several private and public companies convinces me there is a real risk that proposed "reforms" will prove to be more burdensome and costly to shareholders than the abuses they were intended to correct.

7. Traditionally, U.S. regulation of investments and securities has focused on *disclosure,* leaving actual investment and operational decisions to investors, financial advisers, brokers, fund boards, managers, etc. In general, Congress and the SEC have upheld the idea that sunshine is the best investor protection, and that it is rarely advisable to impose operational requirements on business corporations or mutual funds. The stunning economic record of the American economy strongly validates the wisdom of this approach.

8. *The Securities & Exchange Commission is the appropriate agency to monitor and supervise the mutual fund industry.* My colleagues and I favor additional funding for the SEC so it will have adequate resources to perform this role.

9. Finally, I note that *all good ideas need not be enacted into law.*

Many interesting and worthwhile proposals have been advanced for improving governance and operational reform in the mutual fund industry. Some of these are well-suited for some funds, less so for others. Ultimately, consideration of many of these reforms may be better left to the discretion of fund boards and management. Along with proper disclosure, competition among funds is likely to give shareholders a fairer and more efficient outcome than imposing additional unnecessary supervision on an industry that is already heavily regulated.

With these considerations in mind, and with concurrence of many, though not all, of my colleagues in the industry, I offer the following comments and recommendations. I have been asked to particularly discuss issues of governance and director independence. So let me start there.

Governance

In general, we agree with the idea that a super-majority of fund directors should be independent. Most of us, therefore, *favor* the requirement that two-thirds or 75 percent of fund boards be independent. (H.R. 2420, S. 1822, S. 1971, S. 1958)

It is important to understand, however, that if such a requirement is imposed and, at the same time, the definition of independent (or not "interested") director is changed, the results could be quite drastic.

Take the example of one particular board with which I am familiar. The board has 11 directors, 10 of whom are independent under existing law. The most extreme proposed definition (calling for a 10 year cooling off period for former adviser employees) would create a Hobson's Choice for the board. It could discharge several

directors and lose the expertise of experienced board members. Or it could reach the new standard by adding 13 new directors and, thereby, creating an unworkably large board. Neither of these outcomes is good for shareholders.

So, Congress should be cautious in amending the definition of an "interested" director. If Congress wishes to increase the cooling-off period, it should also permit a phase-in period of sufficient length to accommodate turnover in a natural manner as present directors retire.

We *favor* the proposal (S. 1822, S. 1971, S. 1958) that fund board nominating committees be composed of independent directors. This issue is already largely addressed by SEC rules adopted in 2001 that require that, for virtually all funds, the independent directors must nominate and select the independent directors. There is also some agreement among us that it is usually a good idea for a fund board chairman to be independent. Accordingly, some of us *favor* such a requirement.

But others of us wonder whether this is *always* the best arrangement. Are there not some circumstances in which a chairman who is part of fund management better serves shareholders? And, in any case, why must this be mandated by law? Why can't this matter, if properly disclosed, be left to the discretion of investors themselves? If they think an independent chairman is a better approach, they will have many funds from which to choose. But if they are indifferent to this issue or, for some reason, think some other arrangement is preferable, why should they not be permitted to invest as they choose?

Financial Expert

We *oppose* the requirement that each board include at least one "financial expert," a provision that will impose a serious hardship on small funds.

Even for large fund groups, such as ours, this requirement will adversely affect our ability to attract "experts" to serve on our boards because of the implication of additional liability attributed to persons so designated. Frankly, when someone is designated as such an "expert," it is like painting a bull's eye on his or her chest. That person will automatically be subject to more scrutiny, more criticism and, potentially, more liability.

I know from firsthand experience as a corporate director, and as one who has been responsible for corporate director searches, that this requirement will make it a lot harder to attract and retain highly qualified board members.

We favor instead the current Sarbanes-Oxley standards, which require disclosure of whether a fund has a financial expert on its Audit Committee.

Other Audit Committee Requirements

We believe that additional audit committee requirements, if needed, should be provided by SEC rule. Many of the Sarbanes-Oxley requirements have already been imposed on fund audit committees by the SEC. If there is remaining doubt about the authority of the SEC to do so, it would be appropriate for Congress to explicitly grant such rulemaking power to the Commission.

Chief Compliance Officer

We *favor* requiring the Chief Compliance Officer to report directly to the board, as provided by H.R. 2420 and S. 1971. I note, however, SEC Rule 38a–1 already substantially requires this.

Director Review of Soft Dollar, Revenue Sharing & Directed Brokerage

Three pending bills establish a fiduciary duty for boards to review the soft dollar, revenue sharing, and directed brokerage arrangements. We see *no need* for legislation on this matter since, in our view, the law currently imposes the duty on a fund board to carefully monitor the use of fund assets. I should also note that directed brokerage and certain aspects of revenue sharing are the subject of the SEC's rulemaking.

Certifications by Independent Chairman and/or Independent Director

We are *against* proposals to require various certifications by the fund board chairman and/or independent directors. Such requirements entail too much director involvement in fund management and adversely affect the independence of directors. We believe such certifications should be made *to* the board, not *by* the board itself.

If the most extreme proposed independent director certification requirements were adopted, several things would quickly happen:

First, many independent directors would throw in the towel. They would just resign. Second, the remaining directors would have to get so deeply entangled in day-to-day operations of the company that they would no longer, as a practical matter, be independent. Third, the cost of D&O insurance would skyrocket.

So, we believe such certifications should be made *to* the board, not *by* the board. If the board is going to continue its historic role as an independent watchdog, it should receive, not prepare, such certifications.

Ethics Code

Our board has a well-established code of ethics (as required by Rule 17j–1 of the Investment Company Act) and regularly reviews compliance by board members and management company personnel.

But we are skeptical of requiring that ethics violations be posted on fund websites (S. 1971). Doing so would raise questions of fairness, libel, and administrative practicality, and entails so many "due process" issues that the result would be to scuttle an otherwise worthy process.

Disclosures

In general, we *favor* disclosure. Truth is user-friendly for our shareholders, and we support giving the public all the facts needed to make good investment decisions.

In reviewing the numerous proposed disclosure requirements, we note that many of the matters included in pending legislation are already required by current SEC and NASD rules, and are likely to be enhanced by proposed rules.

Four pending bills require disclosure of the structure and method for determining portfolio manager compensation and the ownership interest of managers. We have no objection to making such disclosures.

We are troubled, however, by the requirement of S. 1971 to disclose the exact amount of manager compensation. This unnecessarily intrudes on the privacy of portfolio managers and creates a competitive disadvantage for mutual fund companies in attracting and holding managers.

We have no objection to additional disclosure of share ownership by directors, as already contained in the Statement of Additional Information. But the proposal to report if a director "does not" own shares seems to us awkward. On balance, we prefer affirmative, rather than negative, disclosure.

We also wish to point out that increasingly complex disclosure tends to make various required documents difficult to understand and, if carried too far, the purpose of informing investors is actually undermined, rather than enhanced.

Mutual Fund Oversight Board

There has been some discussion of establishing a new Mutual Fund Oversight Board. We are *against* this idea because the SEC already has invaluable regulatory expertise that any new agency could acquire only over a long period of time.

Moreover, we believe splitting mutual fund regulation from exchange and brokerage regulation will weaken the regulatory framework and result in confusion and fragmentation.

It is our strong view that Congress should instead provide additional funding so that the SEC can properly enforce statutory and regulatory requirements. This seems a more practical and direct approach.

4:00 P.M. Closing

We *favor* the so-called "soft close" concept (H.R. 2420, S. 1971), which requires strict monitoring of intermediaries to assure that all buy/sell orders are received either by the fund or the intermediary prior to the time funds calculate their net asset value (usually 4 p.m.).

The "hard close" alternative (S. 1958) would require that all transactions be received by the fund itself (or its transfer agent or a registered clearing agency) prior to 4 p.m. This means orders placed through brokers or other intermediaries would have to be cut off several hours earlier to assure receipt prior to 4 p.m.

The practical result might be that Pacific Time zone brokers would be forced to put all orders received after 9 or 10 o'clock into the following day's business. So, for some investors, order execution would be delayed for more than an entire business day, hardly fair to such investors.

In our funds, a majority of shareholders place their transactions through intermediaries. So the "hard close" concept would be to the disadvantage of millions of our accounts.

In our opinion, the "soft close," with strict monitoring of intermediaries, assures a level playing field for all investors without implementing the more draconian "hard close."

Market Timing

We *favor* forthright disclosure by funds of how frequently investors will be permitted to trade in fund shares. And we *favor* disclosure of the penalty to be invoked by the fund on those who violate the guidelines.

But we are *against* mandatory restrictions or a one-size-fits-all prohibition on quick turnaround trading. The overwhelming majority of mutual funds are designed for long-term investors with a time horizon of years, not months and certainly not days or hours. Many funds also permit controlled asset allocation programs. But if a particular fund or complex wishes to offer itself to market timers, we see no reason why this should be prohibited, if properly disclosed.

We also favor full disclosure of any trading restrictions that funds may place on adviser personnel to limit the frequency of their trades. In general, however, we think such personnel should be subject to the same limitations as other investors.

RICO

One pending bill, S. 1958, proposes to apply RICO to the mutual fund industry. We are *strongly opposed* to this concept and feel that it is completely inappropriate for the mutual fund industry.

Other Issues

Mr. Chairman, again let me express my appreciation to you and Members of the Committee for the opportunity to be here today. I hope you and your staff will call on my colleagues and me for help as you consider legislation regarding the mutual fund industry. Thank you.

PREPARED STATEMENT OF VANESSA C.L. CHANG

INDEPENDENT DIRECTOR, NEW PERSPECTIVE FUND

MARCH 2, 2004

Introduction

My name is Vanessa Chee Ling Chang. I serve as an Independent Director and Chair of the Audit Committee and member of the Contracts Committee for the New Perspective Fund, a member of the American Funds family. The fund, whose board I joined in March 2000, is advised by Capital Research and Management Company, has assets in excess of $30 billion and is sold through third parties. I also serve as an Independent Director, Audit Committee and Governance and Nominating Committee member for Inveresk Research Group, Inc., a Nasdaq-listed company providing contract research services for drug development to biotechnology and pharmaceutical companies. I am a Certified Public Accountant and worked for Peat Marwick, now KPMG, in the Audit Department and later in Corporate Finance. I was a partner from 1986 to 1997.

I appreciate the opportunity to appear before the Committee to discuss mutual fund operations and governance from my perspective as an independent director.

I am greatly dismayed by the abuses that have come to light in the mutual fund industry over the past few months. In particular, I am distressed that some industry participants apparently chose to benefit themselves at the expense of fund investors, resulting in the current crisis of confidence. Their behavior is so contrary to my experience with my fellow directors at the American Funds family, the associates at Capital Research and Management Company and independent directors of other funds whom I have had the opportunity to know and with whom I have discussed industry issues. I have found these individuals to be smart, responsible, conscientious, inquisitive, and outspoken. I commend Congress' and the regulators' interest, especially the Securities and Exchange Commission, in restoring investor confidence and faith in our capital markets. Clearly, some regulatory response to the recent events is necessary but it must be well considered and practical. I thank this Committee for its thoughtful consideration to determine what legislative response may be necessary.

I will discuss:

- the organization of our boards and how we work;
- service on a single versus multiple boards;
- the independent chair proposal; and
- the independent director certification proposals.

Duties and Responsibilities of Fund Boards of Directors

In evaluating proposals that would reform fund governance, it is important to understand how investment companies operate and, in particular, the role of independent directors. Today, I will share with you how I go about discharging my duties and responsibilities in the shareholders' best interests.

Before I joined the board of New Perspective Fund, my experience had been with traditional public corporations. Therefore, I had to learn very quickly the distinctions between my role as an independent director of a mutual fund versus that of a corporate director. A shareholder invests in a mutual fund because the investment strategy and process of the investment adviser is attractive. In fact, the investment adviser created the mutual fund to offer its services on a pooled basis to the investing public who could not otherwise afford the services of a professional money manager. A fund has no employees—the adviser and service providers manage its operations and provide staff. As fund directors, we are not charged with managing any of the fund operations. We serve the interests of fund shareholders through our oversight of the fund's operations and of the fund's service providers such as the adviser, auditors, and the like.

Under the Investment Company Act and SEC rules, independent directors have particular responsibilities to protect fund shareholders against conflicts of interest between the fund and its adviser and other service providers. One prominent example of the independent directors' role in protecting against conflicts of interest is the renewal of a fund's advisory contracts. At New Perspective Fund, we receive substantial education from the adviser throughout the year, especially in connection with the annual contract renewal. In advance of the first of two board meetings during which we will be discussing the contracts, we receive extensive information from the adviser that we review carefully and compare some of the information with that of the prior year. The first meeting is devoted to asking questions of the adviser and/or requesting additional information. I have never felt inhibited in asking questions or raising issues that may not be on the agenda or in the book. After questioning management, the independent directors and our independent counsel meet in executive session to discuss the information in connection with the renewal of the contract. At the second board meeting we receive the additional information and discuss any further issues. Only after we are all satisfied do we vote on the advisory contracts. All independent directors sit on the Contracts Committees and they vote separately on contract matters.

My duty as a Director is to feel comfortable not just at one point in time. As a result, throughout the year I look for or request information that satisfies me that the controls, systems, and procedures continue to be in place. Our board regularly takes the initiative to identify matters for the adviser to report on at board meetings or in special sessions. Management is always responsive to our requests.

We meet in clusters. American Funds have nine clusters ranging from one to twelve funds per cluster. For example, the Fixed-Income funds may meet in a cluster that consists of 12 funds, while my cluster has only one fund. Although I only serve on New Perspective Fund's Board, our meetings coincide with board meetings of two other global equity funds, EuroPacific Growth Fund and New World Fund. We meet quarterly over consecutive days. We often have joint board or Audit Committee meetings to discuss issues common to us all, such as discussion of a particular industry or country or the internal control review (SAS 70) performed by an independent audit firm. After the joint meetings, each Board then meets separately, including our executive sessions.

Independent directors are nominated by the Nominating Committees that consist solely of independent directors. We have a separate committee consisting of one independent director from each of the nine clusters to oversee the shareholder operations performed by a subsidiary of Capital Research and Management Company. This committee meets bi-annually with at least one meeting taking place at one of the four service centers.

Finally, we are encouraged to attend independent educational seminars and hold biennial 2-day seminars for all American Fund directors at which we discuss various topics outside the context of regular board and committee meetings.

Service on Multiple Fund Boards

The proposed reforms for fund governance include questions concerning service by independent directors on multiple boards. Although I serve on a single board, I believe there are efficiencies and economies of scale to be achieved from service on multiple boards. I have experienced these efficiencies as a result of the joint board and/or Audit Committee meetings in which I have participated.

While our "cluster" arrangement works for us, I can appreciate that different complexes may find other structures preferable. I do not believe that Congress or the SEC should dictate the number of boards on which an independent director can sit. The factors affecting a director's ability to serve on multiple boards are quite varied and subjective. I think that the SEC's proposal to require directors to evaluate, annually, their ability to serve the shareholders of the funds they oversee is an effective way to address this issue.

Fund Governance Reforms

As an American by choice and not by birth, I have great faith in this committee and the legislative process that any actions will be for the benefit of the individual investor/shareholder. Some of the reforms suggested will, in my opinion, improve the governance system, yet others threaten to add more cost and burdens on boards and fund shareholders without any benefit.

As I mentioned, I believe certain of the proposed reforms would be beneficial and most likely to have an impact on how I discharge my duties as an independent director. For example, I support:

- broadening the definition of "interested person" to draw a clearer line between independent directors and persons with ties to the fund's adviser or other service providers;
- requiring 75 percent of the board to be independent;
- self-assessing annually the board's performance;
- meeting separately with only independent directors at least four times a year;
- implementing nominating committees consisting only of independent directors; and
- requiring a fund's chief compliance officer to report directly to the independent directors.

Independent Chair

I do not support the proposal that every mutual fund board must have an independent chair. Although our Board does not have an independent chair, we have never been prevented from adding items to the agenda or discussing issues that are not on the agenda. I also believe that the quality of our Board meeting agendas is a function of the input from the independent directors, as well as the interested chair, the officers of the adviser, independent legal counsel, and the fund's auditors. They reflect an open and challenging dialogue between the adviser and the independent directors. While some funds may benefit from an independent chair, I do not agree that the chair should be an independent director in every case because:

- An independent chair would not have the day-to-day exposure to the fund's operations to understand and raise current issues or anticipate potential problems before they become "problems." In order to gain that kind of knowledge, the independent chair may find himself/herself with a full time job, thereby negating his/her independence from the fund's adviser. This also would increase the cost to shareholders.
- No two-fund families and advisers have the same culture; accordingly, one size does not fit all.

My recommendation would be to allow boards to decide whether to have an independent chair or lead director. Independent boards should vote and appoint either an independent chair or lead director, whichever they believe would best benefit shareholders of their funds.

Certification Requirements

Pending legislative proposals would require that independent directors or an independent chair certify to a number of matters. These include whether there are certain policies and procedures in place, as well as whether those policies and procedures have been followed. I strongly believe that an independent director should not be required to certify to matters about which directors could have no direct knowledge. I am particularly troubled by proposals that would require independent directors to certify that a fund is in compliance with its policies and procedures to calculate daily net asset values and oversee the flow of funds into and out of the fund. I inquire and am satisfied that there are controls, procedures, and policies in place to calculate net asset values and oversee fund flows. While we receive reports on these issues at board meetings, directors do not and should not have the obligation to monitor compliance on a day-to-day basis. Some of these certifications also appear to confuse the role of an independent director of a mutual fund with the role of the distributor/financial adviser in serving the ultimate investor/shareholder. For example, while I can be satisfied that all the fund's share classes bear appropriate fees and expenses, I have no way to determine whether a given share class is appropriate for a particular investor without knowing that investor's investment objectives, holding period, etc. That is not my role as an independent director of a mutual fund.

I also am concerned about the implications of independent director certifications. Do these certifications expose us to additional liability or remove our business judgment? As an independent director, do I add value if I must rely on sub-certifications

from the people who really are in a position to monitor day-to-day compliance with these operations? Am I suggesting to fund shareholders that additional protections are in place, protections that I could offer only if I were to immerse myself in the day-to-day operations of the fund? If I did take it upon myself to become so immersed, am I now performing the role of management, and am I still independent? The whole area of certifications, as proposed, crosses the line from oversight to day-to-day management, and sometimes may cross the line from investment adviser to distributor. I also believe that the certification could cause a problem for funds attracting and retaining qualified persons as fund directors, which certainly would not be in the best interest of shareholders.

It is my view that these kinds of certifications, if required, should be redirected to those persons who are responsible for managing the operations of a fund or its distribution, as appropriate. This would place the responsibility directly on the persons who are capable of conducting the types of review necessary to verify compliance. To place this responsibility on directors would badly confuse our oversight responsibilities with the operating responsibilities of management.

Conclusion

I appreciate the opportunity to address the Committee and to share my perspective as an Independent Director with you. I trust that I have given you a better understanding of independent directors' roles in the fund industry. I also hope that you take into consideration that the vast majority of independent directors take their responsibilities seriously as you evaluate the numerous proposals relating to fund governance.

PREPARED STATEMENT OF MARVIN L. MANN

CHAIRMAN OF THE INDEPENDENT TRUSTEES, THE FIDELITY FUNDS

MARCH 2, 2004

I. Introduction

Chairman Shelby, Ranking Member Sarbanes, and distinguished Members of the Committee, my name is Marvin Mann. I am Chairman of the independent trustees of the Fidelity Funds. I appreciate this opportunity to appear before you today to discuss mutual fund governance and to describe how the Fidelity Funds Board does its job.

The Fidelity Funds are the largest mutual fund family in the United States, with assets of over $900 billion and about 19 million shareholders as of December 31, 2003. As an Independent Trustee, it is my job to oversee the Fidelity Funds and to help protect the interests of the many shareholders of the Fidelity Funds. In that capacity, I have had the good fortune to work with a group of independent trustees who are dedicated to acting independently in pursuing the best interests of the Fidelity Funds and their shareholders. The way in which we go about our job may be instructive.

Before I begin, I want to applaud this Committee for the leadership it demonstrated in connection with the enactment of the Sarbanes-Oxley Act of 2002. This Act recognized that corporate governance generally could best be improved by enhancing the role of independent directors, strengthening auditor independence, subjecting internal controls to more rigorous scrutiny and reinforcing the process by which information gets "reported up" through a corporation—ultimately, when necessary, to the board of directors. Without this type of system, corporate boards, including fund boards, cannot do their job. These types of reforms, rather than efforts to mandate a specific "one-size-fits-all" board of trustees model for all mutual funds, are the most effective means to improve mutual fund governance, compliance, and accountability.

Today, I would like to address mutual fund governance matters. In addressing these matters, specifically in Parts II, III, and IV of this testimony, I am expressing not only my own views but also those of the Governance and Nominating Committee of the Fidelity Funds, all of the members which are independent trustees.[1]

In addition, stepping from my role as an Independent Trustee of the Fidelity Funds and speaking more broadly about public policy issues affecting the entire fund industry, I would also like to address three proposals that I believe will im-

[1] The views expressed in this testimony may not represent the views of Fidelity Management & Research Company. The views expressed in Part V of this testimony reflect my own views.

prove mutual fund regulation and benefit investors in a meaningful way. I encourage Congress and the SEC to give these proposals serious consideration.

II. Characteristics of Effective Boards of Trustees

I know that you are interested in how fund boards oversee a large number of funds in an effective manner. An engaged and well-functioning board of trustees can undertake this responsibility and do the job well. To describe how this can be done, I would like to identify what I believe are the five general characteristics of a well-functioning board. Having been an Independent Trustee for approximately 10 years and a member of corporate boards for many more, I have had ample opportunity to observe and think about the characteristics of a well-functioning board and to put my thoughts into practice. The Fidelity Funds Board incorporates these characteristics. It is important to understand the role of a board of directors in the corporate governance of mutual funds and, for that matter, of companies generally. The role of a board of directors is primarily one of oversight. A board of directors typically is not, and should not be, involved in the day-to-day management affairs of the company. With this in mind, I would now like to address the five characteristics of a well-functioning board.

First, a well-functioning board recruits high quality, highly experienced people, who are independent, to serve as trustees. In the case of the Fidelity Funds Board, the independent trustees have established criteria that are aimed at recruiting such people who also have the time, the commitment, the expertise, the judgment and, most importantly, the values to serve as independent trustees. One of the most important values, in addition to integrity, is the disposition to act independently in fact. We expect that the independent trustees, as fiduciaries, will play an active role and, as necessary, an adversarial role in pursuing the best interests of the funds and their shareholders.

We also focus our Trustee recruiting efforts on people who are highly experienced in overseeing large, complex organizations. Trustees with this type of experience have the expertise, disposition, and the instincts to guide the formulation of processes that enable them to: *(i)* oversee many complex issues in an effective manner, *(ii)* identify areas that require detailed board attention, and *(iii)* establish reporting mechanisms that provide assurance that appropriate actions are promptly taken.

We make an effort to recruit senior executives from a variety of fields, including business operations, finance and accounting, marketing, investment management, and Government service. Trustees with diverse backgrounds bring complementary skills, strengths, experiences and insights that enhance our ability to provide effective oversight.

The process of recruiting independent trustees is crucial. It requires a lot of effort, because 10 of the 14 trustees of the Fidelity Funds, or over 70 percent, are independent. Substantially more effort would be required if a limit were to be imposed on the number of funds that a single board could oversee. As the number of boards overseeing funds increases, there would be more board seats to be filled without any increase in the number of suitable candidates.

Responsibility for all aspects of the Independent Trustee identification and recruitment process is vested in the Governance and Nominating Committee, which I chair and which is composed exclusively of independent trustees. More recently, in order to assure that we consider a broader range of qualified candidates, the Governance and Nominating Committee has retained an executive search firm to assist us in canvassing for qualified people.

The Governance and Nominating Committee consults with the other independent trustees throughout the selection process. The decision to select an independent trustee for our board is made by all of the independent trustees. Of course, ultimately our selections must be approved by fund shareholders.

The second characteristic of a well-functioning board is time commitment. Trustees must make the significant time commitment necessary to prepare for and fully participate in board meetings. The Fidelity Funds' Board has regular meetings 11 times a year, almost always in person. Special board and committee meetings are not infrequent. Regular meetings generally take the better part of 2 days. Board members are expected to review an extensive amount of material prior to each meeting. Preparation time can span several days prior to the meeting. In order to contribute meaningfully to board discussions and meetings, trustees therefore must be in a position to make a real commitment of their time. Often, potential candidates who would otherwise be extremely capable independent trustees have been eliminated from consideration due to their inability to make this commitment.

The third important characteristic is the ability to exercise a strong voice in setting the agenda for board and committee meetings. The Fidelity Funds independent trustees pay a great deal of attention to structuring the agenda. First, we establish

an annual calendar to schedule all of the matters that require board action and review over the course of the year, including individual fund portfolio reviews. Each month we consider whether additional matters should be added to the agenda for that month's meeting. At every board meeting, we reserve a substantial amount of time for executive sessions limited to independent trustees. At these meetings we discuss the agenda, the agendas for future meetings and other matters relating to our oversight of the Fidelity Funds.

This process ensures that issues important to fund shareholders are considered. As Chairman of the independent trustees of the Fidelity Funds, I not only approve meeting agendas, but I also make sure that they reflect my input, as well as the input of committee chairs and the other independent trustees.

The fourth characteristic of a well-functioning board is access to information and resources. Trustees cannot exercise oversight and fulfill their fiduciary duties in a vacuum. The independent trustees of the Fidelity Funds have our own legal counsel. We need and receive regular reports and detailed presentations from Fidelity on a broad range of matters related to our oversight of the funds. Our requests for information are promptly addressed. As necessary, we schedule tutorials to address additional questions and provide additional analytical data that we may need to support the Board's decisionmaking process. Importantly, Fidelity has the resources and commitment to keep the board of trustees fully informed.

The fifth and final characteristic is organization. A well-functioning board needs to have effective and flexible structures and processes that govern the board and its committees. These structures and processes must be designed to ensure that all necessary work is completed, based on the right mix of information.

The Fidelity Funds Board has developed a well-defined committee structure that is a critical factor in our ability to oversee the funds. The structure, mission, and membership of each board committee are decided solely by the independent trustees. These committees are chaired by, and consist exclusively of, independent trustees. This assures that the committee agendas and decisions are controlled by the independent trustees.

We have a Nominating and Governance Committee, an Audit Committee, an Operations Committee, a Fair Value Oversight Committee and a committee that focuses on brokerage, distribution and shareholder services. We also have divided the universe of Fidelity Funds into three categories, based largely on investment focus, and we have established a separate committee to oversee each category. We also have committees that lead the board's review and negotiation of the fund's investment advisory contracts.

The committee structure, coupled with the other elements that I have described, make it possible for the independent trustees to consider the issues faced by all of the Fidelity Funds in an effective manner.

It may be much more difficult for a board to oversee a large number of operating companies in diverse businesses, each with different groups of shareholders. But there are important differences between operating companies and mutual funds. Funds within the same fund complex share a substantial number of common elements. These common elements include distribution, fair value pricing procedures, brokerage allocation processes, administrative and operational processes (such as transfer agency, custody, and IT issues), audit, internal control and compliance processes, and many investment management processes. And, unlike operating companies, funds do not have separate employees or substantial physical assets and operating facilities. Rather, mutual fund boards generally oversee a relatively limited number of service providers that furnish specified services to each of the funds in the complex. While there may be variations in the specific services that each fund receives, they are generally variations of the common services that each fund must receive. Issues arising in connection with these common elements often must be resolved in a uniform way—a resolution that can most readily be achieved by a single unified board.

The time and effort involved in overseeing a large number of funds with common elements is, therefore, not the same as would be required to serve on separate boards of the same number of unaffiliated operating companies. A well-functioning unified fund board can leverage its knowledge of the common elements, address them in an efficient manner and in the process do a superior job in exercising its fiduciary duties and looking after the best interests of fund shareholders.

Our committee structure comes into play here and really makes it possible for the independent trustees to oversee all of the Fidelity Funds. The common elements of fund operation, such as fair value procedures, internal controls and audit functions, brokerage allocation, shareholder services and distribution, are addressed by committees that have oversight responsibilities for these areas across all funds in the complex.

We also have processes that allow us to identify issues that are unique to specific funds. The Board of Trustees' oversight of fund performance provides a good example. The independent trustees receive monthly reports on the performance of all of the funds. This includes information comparing the performance of each Fidelity Fund to a peer group of funds and an appropriate securities index or combination of indices. Unusual performance that may require attention is immediately obvious to all of us. The Fund Oversight Committees also conduct regularly scheduled in-depth reviews of the funds they oversee. Prior to each fund review meeting, the board receives written reports and analyses from the portfolio manager to assist the oversight committee's preparation for the meeting. This material provides the independent trustees with essentially the same information that Fidelity management uses in its periodic reviews of portfolio performance. At the meeting, the oversight committee discusses this data and other aspects of fund performance in depth with the portfolio managers and their supervisors. The highlights of these meetings are reported to and discussed by the full Board. In this manner, all of the independent trustees are made aware of the significant issues faced by each of the Fidelity Funds and any actions required to remedy them.

Another good example of the process that allows us to identify issues that are unique to specific funds relates to our review of the funds' investment management agreements with Fidelity. I will discuss this in the next section of my testimony.

To sum up, the five characteristics of a well-functioning board are people, time commitment, the authority to set the agenda, access to information and organization. When all five of these elements are present, a board should be able to effectively fulfill its oversight and supervisory responsibilities. This certainly is the case with the Fidelity Funds Board.

You will note that one characteristic that I did not include is having an independent chairman.

A well-functioning board can, and in the case of the Fidelity Funds Board does, act independently and effectively without having an independent trustee serve as chairman. Independent trustees should have the authority to select an independent chairman, and the independent trustees of the Fidelity Funds have that authority now. I believe that the key structural component of assuring that independent trustees are in a position to control the board is to assure that they constitute a substantial majority of the board, as the SEC has proposed. The independent trustees of the Fidelity Funds further reinforce their independence by setting their own compensation. The investment adviser and management trustees are not involved in this determination.

I am sure that there are some fund boards where governance might be improved if a particular individual, who also happened to be an independent trustee, served as chairman. In the case of many funds, that may not be the case. In each case, the independent trustees are the parties in the best position to make this decision.

The SEC and the Investment Company Act entrust to independent trustees a number of important decisions with respect to various matters, including the approval of investment advisory contracts, underwriting agreements and determinations under various rules that address conflicts of interest. Removing from our discretion the election of the board chairman seems to me to be in basic conflict with that approach, particularly when, as a practical matter, the independent trustees must be at least a majority of the board. The Sarbanes-Oxley Act strengthened corporate governance for public operating companies. Wisely, it did not require corporate boards to have independent chairs. I do not believe that the case has been made that an independent chairman is essential to improving mutual fund governance. I therefore feel strongly that mandating a governance structure that requires an independent chairman is not in the best interests of all funds or all shareholders. It may be appropriate, however, to require that a majority of the independent trustees of a fund have the authority to elect and remove the board chairman.

III. Consideration of Investment Management Contracts

One of the most important functions of a mutual fund board of trustees is its annual consideration of the investment management contract between the mutual fund and its investment adviser. The approval and annual renewal of the investment management contract requires the approval of a majority of the independent trustees. The Fidelity Funds Board of Trustees receives an enormous amount of information in connection with our review of the funds' investment management contracts with Fidelity and any affiliates of Fidelity that serve as sub-advisers (who, for purposes of this testimony, I refer to collectively as "Fidelity").

First, however, I want to dispel any notion that all of the issues relating to investment advisory contracts are considered at a single meeting. The formal contract reviews occur over a series of meetings. Moreover, we receive data and information

relevant to that review throughout the year, including the fund reviews that I discussed above.

In reviewing the contracts, the Board of Trustees considers a number of factors. We receive data and information from Fidelity to support our consideration of these factors, including comparative data relating to peer groups of funds. I should also emphasize that the management fees paid by a large number of the Fidelity Funds include a performance-based adjustment, which can increase or decrease the fee. Thus, we receive information on the impact of performance adjustments to the management fees.

The factors that we consider typically include the following:

- *Benefits to Shareholders.* We consider the benefit to shareholders of investing in a fund that is part of a large family of funds offering a variety of investment disciplines and providing for a large variety of fund and shareholder services.
- *Investment Compliance and Performance.* We consider whether each fund has operated within its investment objective and its record of compliance with its investment restrictions. We also review each fund's investment performance as well as the performance of a peer group of mutual funds, and the performance of an appropriate index or combination of indices (approved by the independent trustees).
- *The Investment Advisers' Personnel and Methods.* As discussed above, we have annual meetings with each fund's portfolio manager. We review each fund's investment objective and discipline. The independent trustees also have discussions with senior management of Fidelity responsible for investment operations and the investment discipline of each fund. Among other things that we consider are the size, education, and experience of Fidelity's investment staff, their use of technology, and Fidelity's approach to recruiting, training, and retaining portfolio managers and other research, advisory, and management personnel.
- *Nature and Quality of Other Services.* We consider the nature, quality, cost, and extent of administrative and shareholder services performed by Fidelity and its affiliates, under the investment management contracts and under separate agreements covering transfer agency functions and pricing, bookkeeping and securities lending services, if any. We also consider the nature and the extent of Fidelity's supervision of the third-party service providers, principally custodians and subcustodians.
- *Expenses.* We consider each fund's expense ratio, and expense ratios of a peer group of funds. We also consider the amount and the nature of fees paid by the shareholders.
- *Profitability.* We consider the level of Fidelity's profits in respect of the management of the Fidelity Funds, including each fund. This consideration includes an extensive review of Fidelity's methodology in allocating its costs to the management of a fund. We consider the profits realized by Fidelity in connection with the operation of a fund and whether the amount of profit is a fair entrepreneurial profit for the management of a fund. We also consider Fidelity's profits from nonfund businesses that may benefit from or be related to a fund's business. We also consider Fidelity's profit margins in comparison with available industry data.
- *Economies of Scale.* We consider whether there have been economies of scale in respect of the management of the Fidelity Funds, whether the Fidelity Funds (including each fund) have appropriately benefited from any economies of scale, and whether there is potential for realization of any further economies of scale.
- *Other Benefits to Fidelity.* We consider the character and amount of fees paid by each fund and each fund's shareholders for services provided by Fidelity and its affiliates, including fees for services like transfer agency, fund accounting and direct shareholder services. We also consider the allocation of fund brokerage to brokers affiliated with Fidelity, the receipt of sales loads and payments under Rule 12b–1 plans in respect of certain of the Fidelity Funds and benefits to Fidelity from the use of soft-dollar commissions to pay for research and other similar services. We also consider the revenues and profitability of Fidelity's businesses other than its mutual fund business, including Fidelity's retail brokerage, correspondent brokerage, capital markets, trust, investment advisory, pension record keeping, insurance, publishing, real estate, international research and investment funds, and others. We also consider the intangible benefits that accrue to Fidelity and its affiliates by virtue of their relationship with each fund.

I have outlined a significant number of factors and, as you can imagine, that means we review a significant amount of information. As I have just discussed, our committee structure makes our review of this information more efficient. The independent trustees and Fidelity also spend a great deal of time in developing formats for the presentation of this information that facilitate our review of the data applica-

ble to each fund. As I discussed earlier, a well-functioning board of trustees can and, in the case of the Fidelity Funds, does have the capabilities required to consider all of the factors relevant to the review of each fund's investment management contract.

IV. Independent Director Certifications

Certain legislative proposals would require independent trustees, or an independent board chairman, to certify as to certain matters, such as, depending on the bill, the existence of procedures for verifying a fund's net asset value, the oversight of the flow of assets into and out of the fund, the adoption of codes of ethics, the accuracy of disclosure documents and certain other matters.

The fundamental role of a mutual fund board, and particularly of the independent trustees, is to provide oversight. It is important that the fundamental oversight role of independent trustees not be confused with the operating responsibilities of fund management. Certification is a proper function for entities that manage the fund on a day-to-day basis since it is they, not the board, that must carry out the appropriate risk assessment, compliance, and internal audit responsibilities.

Proper oversight may require a board to review and approve various policies and procedures and receive reports on their implementation. A certification requirement is not necessary to assure that these actions are taken by the board. It would be relatively simple for a regulator to confirm that required procedures have been adopted from a review of the board's minutes and to take appropriate action if the board had failed to adopt required procedures.

Certification requirements would go beyond the requirements imposed on independent directors of other public companies and would not serve any practical purpose. They would only blur the line between the oversight function of the board and the day-to-day management and operational responsibilities of various entities, such as the investment adviser. This is likely to create uncertainty as to the board's duties and potential liabilities. It would have a chilling effect on a board's ability to recruit and retain independent trustees.

For these reasons, I do not support trustee certification requirements.

V. Three Proposals to Improve Regulation

The existing regulatory frame work under which mutual funds operate has served investors well. It continues to accomplish its primary goal of investor protection. There is always room for improvement, however. In that spirit, I would like to take off my Fidelity Funds trustee hat, and instead speak more broadly about issues that affect the fund industry as a whole. In particular, I would like to discuss three proposals that would improve the regulation of mutual funds and the financial markets generally, to the benefit of all investors.

These proposals relate to fund expense disclosure, the use of fund brokerage to acquire certain types of goods and services (sometimes referred to as "soft-dollar" arrangements) and fund distribution costs. I cannot take credit for these proposals because they appear, in one form or another, in various bills that have been introduced to reform the mutual fund industry.

I want to emphasize that these proposals reflect systemic and competitive issues that can only meaningfully be addressed on an industry-wide basis. I raise them today in the hope that my voice will encourage their consideration.

Expense Disclosure

Mutual fund investors could benefit from being told, in dollars and cents, exactly how much it costs for them to invest in their fund. Current rules, which require that fee disclosures be presented in fund prospectuses as a generic percentage of fund assets and a dollar-based hypothetical may be helpful, but they lack precision and specificity. An investor who is interested in getting the full picture of the expenses related to his or her investment would be required to collect data concerning commissions, fees, expenses (to the extent that the data is available) and performance from multiple sources (such as account statements, confirmations and prospectuses). The investor would also be required to keep track of changing account balances and then would have to attempt to make computations of the expenses and net performance on each investment. Investors, even reasonably sophisticated investors, would find this time consuming and difficult. Investors could receive more useful information regarding the costs associated with their investments, and that information could be presented in a better way.

It may be useful for investors to receive information on actual expenses applied to a hypothetical investment amount that would be the same for all funds, so that investors could compare expenses among funds. This type of disclosure requirement was recently adopted by the SEC. I would have liked the SEC to have gone further.

The regulations should require that when an investor buys shares in a fund he or she receive from the fund or the broker a statement setting forth the expenses that the investor will incur. This information should be set forth as a percentage of his or her investment and in actual dollars. The statement would detail all sales charges and itemize all of the fees and expenses that will be paid by the investor either directly or indirectly. The disclosure would be presented so that the investor would not need to search for it in the prospectus or other documents that the investor may receive.

Thereafter, on a quarterly basis, the investor would receive as part of his or her account statement the amount of fees and expenses that the investor actually paid with respect to his or her investment in each fund during the period and, on a cumulative basis, since the beginning of the year. The gross and net returns of the fund investment, in dollars, would also be shown. The goal would be to allow investors who are interested in expense information to receive it in a manner that is readily accessible, easy to understand and, more importantly, in the context of a report that shows what they really earned on their investment.

I believe that this approach should be required for all investment vehicles and accounts. There will be some costs in implementing it, some of which may be borne by investors. But I firmly believe that improved expense disclosure will result in greater investor awareness of expenses. I believe that this increased awareness will, over time, bring competitive pressures to bear on some funds with higher fees. I hope that the SEC will be encouraged to continue to actively pursue the type of expense disclosure that I suggest.

Fund Brokerage and Soft Dollars

Broker-dealers often provide investment advisers with research products and services in exchange for the direction by the adviser of mutual fund and other client brokerage transactions to the broker-dealer. A portion of the commission paid by a client, sometimes substantial, may, in effect be used to pay for these research products and services. In other words, the additional services are bundled with execution and their costs are reflected in commission rates.

These arrangements, known as soft dollars, are specifically permitted under current law. Section 28(e) of the Securities Exchange Act of 1934 provides, in effect, that an investment adviser shall not be deemed to have breached a fiduciary duty solely by reason of having caused the client to pay more than the lowest available commission. The adviser must determine in good faith that the amount of the commission is reasonable in relation to the value of the brokerage and research services provided. The research need not have any relationship to the client that generated the commission; the investment adviser can conclude that the value of the research was reasonable when viewed in terms of its overall responsibilities with respect to clients for whom it has investment discretion.

Brokerage commissions are not reported as fund expenses. Thus, while the use of fund brokerage in connection with soft-dollar arrangements is disclosed in mutual fund disclosure documents, the real costs of the services provided under soft-dollar arrangements are not obvious to investors.

I believe that regulatory action should be taken to “unbundle” fund portfolio brokerage. Specifically, mutual fund brokerage commissions should reflect execution costs and nothing else. I support the recent SEC rule proposal to prohibit the use of fund commissions to reward brokers for sales of fund shares as a step in the right direction. But more needs to be done.

Section 28(e) should be repealed. I acknowledge that repeal of Section 28(e) could result in some significant changes in the way in which brokerage firms and others conduct business. I believe that the SEC should develop a transition plan to allow the repeal of Section 28(e) to take effect on a date certain without inordinate disruptions to market participants.

If an adviser wants to purchase research products or other services such as data terminals, or other nonexecution services, or pay a dealer compensation for fund sales (to the extent currently permitted by law), it would pay for those in hard dollars from its own resources, not from fund commissions. Once soft-dollar arrangements are eliminated, the receipt of research would no longer be a factor in allocating portfolio brokerage.

The end of soft-dollar arrangements may result in pressure to increase investment advisory fees, since investment advisers will need to pay for certain research products and services out of their own pocket. If that is a result, it is a matter that would be considered by fund boards as part of their advisory contract review process. I would expect that any increased advisory fees will in the long run be more than offset by reduced brokerage costs. In any event, the cost of the services, if they continued to be purchased by the fund or through increased advisory fees, would

be reported to investors. Investors would have a much better understanding of the expenses of investing in a mutual fund and would be able to make better-informed investment decisions. At the very least, the cost of research and other services to fund investors would be transparent.

Distribution Costs

The third area where change is called for relates to the way in which the costs of distributing fund shares are paid.

Investors who purchase fund shares through intermediaries pay for the distribution of fund shares in a number of ways. The investor may be charged a commission or sales load at the time they purchase their shares. The investor may also have the option to pay for the services of the intermediaries on a deferred basis through an annual asset-based fee imposed in accordance with Rule 12b–1 under the Investment Company Act. The Rule 12b–1 fees provide for the payment over time of distribution and marketing expenses from fund assets. The investor, of course, bears these expenses through his or her investment in the fund and, in certain circumstances, through a contingent deferred sales load.

Sales loads and Rule 12b–1 fees also have been supplemented, in some cases, by fund brokerage commissions, which may be allocated to sellers of fund shares under certain circumstances. In other words, a portion of the fund brokerage commissions may actually pay for distribution costs.

In addition, the investment adviser also may supplement sales loads and Rule 12b–1 fees by paying for marketing and distribution costs from its own resources. These payments may be for services such as advertisements in newspapers or cash payments to dealers. The latter type of payments, have come to be characterized as "revenue sharing." Revenue sharing payments may cover some of the broker's costs in selling the funds. They may also, in effect, be payments for "shelf-space" or being placed on "preferred lists" at the broker-dealer.

The complexity of these different methods for paying sales charges may make it difficult for investors to fully comprehend the cost of investing in a mutual fund. Certain practices, such as revenue sharing, may create conflicts of interest for the broker that, even when fully disclosed, may be difficult to understand.

I have a three-element proposal that would bring greater clarity to this area. First, sales charges for the services of the broker-dealers or other intermediaries, whether up front or paid in installments, should be paid directly by the investor. A Rule 12b–1 fee should not be used as a substitute for sales loads. The compensation of intermediaries should generally be limited to their receipt of sales loads (whether paid up front or over time) paid by the investors that choose to utilize their services. If brokers want to give investors the option of paying their sales loads over time, they should collect them in installments as is specifically permitted by the rules.

There is no reason why such installment payments should be a fund expense—they can and should be deducted from the shareholder's account. Thus, if a dealer charges a deferred asset-based sales fee in lieu of a front-end load for its distribution efforts, it should be collected by the broker or by the fund complex either by imposing a direct charge on the investor or by deducting the amount from the shareholder's account. These charges would, of course, be fully disclosed and agreed to by the investor.

The SEC recently requested comment on whether Rule 12b–1 should be amended to require this approach. I hope that, after reviewing the comments that it receives, the SEC embraces this approach.

The second element would be to prohibit intermediaries from collecting any additional cash payments (including brokerage commissions) from the fund, its adviser or the adviser's affiliates for distribution efforts. In other words, revenue sharing and other similar practices that involve cash payments to dealers would be prohibited. Accommodation may have to be made for the provision of training and due diligence services by the fund adviser to the dealer sales force.

The third element would recognize that fund complexes themselves have marketing and other unique costs, whether the funds are sold directly to investors or through intermediaries. These fund expenses, which reflect the cost of gathering and servicing assets from tens of thousands of investors, as well as the administrative and regulatory compliance costs, differ greatly from the expenses incurred by investment advisers to pension plans and other large institutional investors. The investment adviser should be permitted to collect a reasonable fee from fund assets to pay for these costs. The fee could be approved by the independent trustees (subject to their fiduciary duty to approve only reasonable fees). The fee could be used to pay for marketing, administrative and shareholder servicing expenses. This fee could not be used to make cash payments to intermediaries (although it could

be used, subject to the NASD rules, to pay for marketing activities directed at intermediaries).

This fee would be separate and unbundled from the investment advisory fee. The investment advisory fee would only represent the charges for portfolio management services and thus would be more directly comparable to the investment management fees paid by pension funds and other large institutional investors.

This three-element approach would have several benefits. First, the amount that the investor pays an intermediary for its selling efforts would be clear and obvious. The amounts would be paid by the investor directly. There would be little need for the complex multiclass fund structures that have been developed to accommodate different distribution arrangements, since the payments would not pass through the fund. The amount would be totally transparent.

Second, eliminating revenue sharing payments would reduce conflicts of interest. Revenue sharing creates potential conflict of interest situations for broker-dealers and other recipients, and has presented significant regulatory issues and resulted in SEC enforcement actions. And I do not believe that the way to address these conflicts is more disclosure—the disclosure simply becomes too complicated even for the more sophisticated investor. I believe that the conflicts created by these practices can best be addressed through prohibition rather than disclosure.

Third, my proposal would recognize the reality that mutual fund sponsors have marketing and other costs. The approach would provide investors with a basis for differentiating between the expenses borne by the fund for these efforts and the expenses borne by the fund for pure portfolio management. This may provide better disclosure for certain investors.

Greater transparency, reduced conflicts, and better disclosure: I think that these are worthwhile objectives.

I appreciate that implementing this approach would create complex transition issues for mutual funds and intermediaries that have been relying on the current system. I believe that these issues could be effectively addressed once the basic concepts are understood.

* * *

These proposals must be implemented on an industry-wide basis. These are not issues that each fund family can choose to address as it sees fit; it would simply not be feasible for a board of trustees to attempt to implement these changes on its own. I have been advised that substantially all of these proposals could be implemented by the SEC. Therefore, in order to ensure industry-wide change, Congress and the SEC should give these proposals serious consideration.

I am certain that you will hear lots of arguments from all sides against these three proposals. If implemented, they will result in some dislocations. They will also result in some up-front costs, mostly for systems development, as well as some ongoing costs, mainly in the reporting area. But we should view these costs in the context of the trillions of dollars invested in mutual funds and the billions of dollars of trading commissions mutual funds generate. Improving market forces through greater transparency and reducing opportunities for conflicts of interest should offset these costs many times over.

Conclusion

The series of hearings on mutual fund regulation being held by this Committee is a great service. These hearings serve to demonstrate, above all, that the issues facing mutual fund investors do not present simple problems or solutions. I believe that this Committee should consider other proposals to help investors better understand their mutual fund investments and the costs associated with them.

Thank you for this opportunity to share my views.

PREPARED STATEMENT OF MICHAEL S. MILLER

MANAGING DIRECTOR, THE VANGUARD GROUP, INC.

MARCH 2, 2004

Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee, my name is Michael Miller. I am a Managing Director at The Vanguard Group, based in Valley Forge, Pennsylvania, where I am responsible for Planning and Development. An important part of my responsibilities is managing our Portfolio Review Group, which selects and oversees third-party investment advisory firms that manage assets for our funds.

Vanguard understands that in the wake of fund trading scandals there is some interest in imposing a direct ban on the ability of an individual to manage both hedge funds and mutual funds. Congress is properly considering this and other issues relating to the operation and regulation of mutual funds. Vanguard appreciates the opportunity to testify on the issue of joint management of mutual funds and other accounts.

While Vanguard does not manage or offer hedge funds, Vanguard is very concerned that a ban on side-by-side management will eliminate a substantial number of investment professionals and investment advisory firms that would ordinarily be available to its mutual fund shareholders. Like Congress, Vanguard is concerned about protecting the interests of mutual fund shareholders. We believe there are ways to effectively protect the interests of multiple clients without taking the extraordinary, and potentially damaging, step of an outright ban on managing both hedge funds and mutual funds.

The Vanguard Group

The Vanguard Group is the world's second largest mutual fund family, with more than 17 million shareholder accounts and approximately $725 billion of investments in our U.S. mutual funds. Vanguard offers 126 funds to U.S. investors and over 35 additional funds in foreign markets. The Vanguard Group has a unique structure within the mutual fund industry. At Vanguard, the mutual funds, and therefore indirectly the fund shareholders, own The Vanguard Group, Inc., which provides the funds with all management services "at cost." Under this structure, all "profits" of The Vanguard Group are returned to our fund shareholders in the form of reduced expenses.

Given Vanguard's mutual ownership structure, all of our management policies, practices, and personal incentives are designed to ensure the growth, safety, and well-being of our fund shareholders' assets. In addition, Vanguard has long maintained a philosophy of fair dealing with our shareholders, and we believe our current investment, business, and disclosure practices are designed to protect their interests. As an industry leader, we are pleased to contribute to the discussions about proposed fund initiatives, and we support appropriate and meaningful reforms at the Federal level to restore investor trust in mutual funds.

Approximately 70 percent of Vanguard's assets are managed by investment professionals employed by The Vanguard Group, Inc. These professionals manage equity index funds, actively managed quantitative equity funds, actively managed and indexed bond funds, and money market funds. The remaining 30 percent of Vanguard's assets, or roughly $220 billion, include actively managed equity and fixed-income portfolios that are managed by third-party investment advisory firms, which are hired and overseen by the funds' boards of trustees with substantial assistance from Vanguard's professional investment staff. In all, 37 of our funds receive portfolio management services from 21 independent advisory firms. We have been selecting and overseeing independent advisory firms for more than 25 years. There are substantial benefits for investors from our approach of using both internal and outside managers:

- *Diversity of Thought.* Vanguard funds and shareholders benefit from the diversity of thought that a variety of external advisers bring to the asset management process. We are able to engage portfolio managers with distinct investment strategies and cultures that would not otherwise be available to mutual fund investors. Investment styles and strategies in fund offerings across the Vanguard complex are distinct.
- *Larger Pool of Investment Talent.* Vanguard funds and shareholders benefit from the additional investment talent that outside managers represent. Vanguard is able to consider a wider range of potential managers for a specific investment mandate and is not limited by geographic or other constraints.
- *Capacity to Grow.* Vanguard funds and shareholders benefit from the flexibility to absorb new investments by engaging additional sub-advisers, without a fund's larger size diluting the effectiveness of existing managers. Introducing new managers can increase a fund's capacity to grow and provide greater economies of scale without diminishing potential investment returns.
- *Diverse Investment Offerings with Consistent Compliance and Service Standards.* Vanguard funds offer diverse investment styles and strategies by using independent advisory firms. Importantly, Vanguard fund shareholders also benefit from a consistent level of compliance oversight and service that a single management company can provide.

Side-by-Side Management

At many investment advisory firms, including Vanguard and all of the third-party advisers we use, individual portfolio managers manage multiple accounts for multiple clients. In addition to mutual funds, these other accounts may include separate accounts (assets managed on behalf of institutions such as pension funds, insurance companies, endowments, and foundations), bank common trust accounts, collective trusts, and other unregistered investment companies. Although, as stated earlier, Vanguard does not manage or offer hedge funds, many asset management firms, including a number of our sub-advisory firms, do. A growing number of mutual fund families hire independent sub-advisers to manage one or more funds. These sub-advisers have other clients, including, in some cases, hedge funds.

While the structure of asset management firms may vary widely, managing money for multiple clients is, and has always been, an inherent feature of a successful asset management firm. Vanguard, for example, has never had a sub-adviser that managed money solely for Vanguard. Importantly, any firm that manages mutual fund assets is a registered investment adviser and, as such, should have substantive policies and procedures that help ensure that the investment professionals manage multiple accounts in the interest of all clients. The law and an adviser's role as a fiduciary demand no less.

Current Practices to Protect Mutual Fund Shareholders

VANGUARD'S APPROACH

Vanguard's external investment advisers are subject to multiple controls and regulations to help ensure that Vanguard fund shareholders are protected. Among these are:

- *Careful Selection.* In the selection of fund advisers, Vanguard carefully evaluates the people, philosophy, process, and performance of a prospective investment management firm. In our view, the integrity and ethics of an advisory firm's investment professionals are as critical as experience and talent.
- *Close Supervision.* Vanguard works closely with our advisers to ensure that they are employing talented and experienced investment personnel, as well as devoting the necessary research and compliance resources in the management of our funds. In addition, the investment professionals in our Portfolio Review Group continually review the performance and portfolio characteristics of our funds. The practices and policies of our advisers are also subject to periodic audits by Vanguard.
- *Federal Regulation and Fiduciary Obligation.* Under the Investment Advisers Act of 1940, all investment advisers are required to perform as fiduciaries and must place the interests of their clients above their own at all times. Advisers also have a fiduciary obligation to treat all clients fairly and equitably.
- *Codes of Ethics.* Each of our advisers has long maintained a strict code of ethics that requires them to conduct their business in a completely ethical manner and adhere to the highest standards of professional behavior. Accordingly, all managers representing Vanguard are expected to act for the benefit of fund shareholders. Vanguard regularly reviews each adviser's code of ethics and its procedures and efforts to assure compliance with its code.
- *Internal Compliance Policies and Procedures.* In addition to the various laws and regulations that govern investment management firms, our advisers maintain formal compliance procedures and policies that are consistent with SEC regulations and designed to address potential conflicts of interest. These safeguards help to assure us that Vanguard funds are not being disadvantaged by any of the firm's other investment activities.

FEDERAL REGULATION

All of the investment advisers who manage mutual funds are required by law to be registered with the Securities and Exchange Commission under the Investment Advisers Act. Therefore, all investment advisers whose business models include side-by-side management of mutual funds and other accounts are also required to be registered under the Advisers Act. All registered investment advisers are subject to the SEC's jurisdiction, inspection, and enforcement powers for all of their business, including the side-by-side management of mutual funds and hedge funds. The SEC's oversight of the investment adviser extends to all of its management activities, regardless of whether the investment activity is otherwise regulated. This provides the SEC with enhanced insight into unregulated investment activity, a degree of transparency that is not present when the unregulated funds or accounts are not managed jointly with mutual funds.

Under the Advisers Act, a registered investment adviser has a fiduciary duty to recognize and disclose potential investment conflicts and carefully manage them

through appropriate policies and oversight. For example, a portfolio manager might hypothetically have an incentive to allocate well-priced trades to a client paying higher fees and more expensive trades to a client paying lower fees. As another example, a manager might hypothetically have an incentive to benefit one client by "trading ahead" of the trading strategies of another client. As noted previously, these potential conflicts are not unique to advisers who provide investment management to a mutual fund and a hedge fund. They exist whenever a portfolio manager advises two accounts that differ in any way, potentially even when a manager runs two different mutual funds simultaneously.

COMPLIANCE POLICIES AND PROCEDURES

Investment firms typically manage potential conflicts, whether involving hedge funds or other types of accounts, through allocation policies and procedures, internal review processes, and oversight by directors and independent third parties. Investment advisers develop trade allocation systems and controls to ensure that no one client—regardless of type—is intentionally favored at the expense of another. Allocation policies are designed to address potential conflicts in situations where two or more clients' accounts participate in investment decisions involving the same securities, which happens frequently. In our experience, there are four core elements of a strong compliance program.[1] These elements are:

- assigning one average price per security for all trades in that security executed for multiple clients;
- when supply of a security is insufficient to satisfy all clients, apportioning the available supply according to equitable, predetermined rules;
- periodic reviews of the trading activity of portfolio managers for anomalous trading patterns involving multiple accounts; and
- independent review of the internal controls relating to the management of accounts, including controls on trade allocation.

These systems can also be, and typically are, examined by the SEC staff during their inspections of registered investment advisers.

The SEC has very recently adopted new rules that will raise industry-wide standards for addressing these potential conflicts for the protection of all investors.[2] The new rules require each mutual fund, and each registered investment adviser, to have written compliance policies and programs administered by a designated chief compliance officer. Fund boards must approve not only the policies and programs of the fund but also of the fund's adviser. Fund chief compliance officers will report directly to fund directors. These changes will enhance the transparency and accountability of fund investment advisers and also require fund directors to review these activities very closely to determine that fair and equitable allocation policies are in place and are being followed.

FIDUCIARY DUTIES OF INVESTMENT ADVISERS

Many investment advisers have adopted practices such as those described previously regarding joint management in order to meet the fiduciary duties that have been required of them by Congress. All investment advisers (whether registered or not) are subject to Section 206 of the Advisers Act, which generally makes it unlawful for an investment adviser to engage in fraudulent, deceptive, or manipulative conduct. Congress enacted the Advisers Act upon declaring that the public interest was adversely affected "when the business of investment advisers is so conducted as to defraud or mislead investors, or to enable such advisers to relieve themselves of their fiduciary obligations to their clients."[3]

An investment adviser has a fiduciary duty to exercise good faith and to disclose all material facts fully and fairly, as well as an affirmative obligation "to employ reasonable care to avoid misleading" its clients.[4] As a fiduciary, an adviser owes its clients more than honesty and good faith alone. Rather, an adviser has an affirmative duty to act solely in the best interests of the client and to make full and fair disclosure of all material facts, particularly where the adviser's interests may conflict with the client's. Pursuant to this duty, "an investment adviser must at all

[1] A detailed list of compliance procedures is included in the Appendix.

[2] SEC Rel. No. IA–2204, "Final Rule: Compliance Programs of Investment Companies and Investment Advisers" (December 17, 2003).

[3] *Investment Trusts and Investment Companies: Hearings on S. 3580 Before the Subcommittee of the Committee on Banking and Currency, 76th Congress, 3d Sess. 202 (1940).*

[4] *Id. at 194. See also, In re: Arleen W. Hughes, Exchange Act Release No. 4048 (February 18, 1948).*

times act in its clients' best interests, and its conduct will be measured against a higher standard of conduct than that used for mere commercial transactions."[5]

Effects of Banning Side-by-Side Management

Banning individual portfolio managers from managing mutual funds and hedge funds would disadvantage mutual fund shareholders and fail to protect them fully.

ACCESS TO INVESTMENT TALENT

Allowing side-by-side management of mutual funds and other accounts, including hedge funds, affords mutual fund investors access to top investment firms and investment professionals. Based on our experience, there is a limited supply of exceptional investment advisory firms and investment professionals. It is important that all investors, including mutual fund investors and 401(k) plan participants (who largely invest through mutual funds), be afforded access to the same universe of investment expertise as may be otherwise available to large institutions or high-net-worth individuals.

Many mutual funds with strong long-term performance records are managed by portfolio managers who also manage other accounts, including in some cases, hedge funds. These professionals have a range of options open to them regarding where they commit their time and talent. Hedge funds can be an attractive option because they allow for a broader range of investment techniques and provide an opportunity to earn higher fees based on performance. Banning the joint management of mutual funds and hedge funds would simply force these managers to choose between mutual funds and hedge funds. The unfortunate and undesirable result would be a reduction in the pool of managers available to mutual fund investors.

MANAGEMENT CONTINUITY AND STABILITY

Such a ban would hurt fund investors in other ways as well. Mutual funds will experience higher portfolio manager turnover, whether the fund is managed by an individual manager or a team, as investment professionals move on to manage other accounts not subject to such a ban.

Allowing management of different types of investment accounts also enhances the ability of investment management firms to retain their best portfolio managers. By managing a wide variety of accounts, investment firms and individual portfolio managers are able to diversify their client bases, as many businesses rationally seek to do. Moreover, the diversity of clients can give a top-quality investment firm greater balance and the ability to better attract and retain talented professionals. This stability benefits mutual fund investors because, in our experience, the continuity and quality of an investment organization is one of the key determinants of long-term investment success for the firm's clients, including mutual fund clients.

Consistent Investor Protection

Importantly, a ban against the side-by-side management of mutual funds and hedge funds would not address potential conflicts that may arise with the management of accounts other than hedge funds. As explained above, such a ban would not prevent a portfolio manager from managing investments for pension funds and hedge funds, or separate accounts and mutual funds, or, for that matter, multiple mutual funds. In any of these instances, the fee structure could be higher for one account than another for a variety of reasons, just as the investment objectives, strategies, and risk characteristics will differ to meet client needs. The potential conflicts of interest that arise in these situations are the same and should be treated consistently to maximize investor protection. Multiple compliance regimes for similar circumstances would introduce complexity and confusion, and would likely weaken rather than strengthen industry-wide compliance around these issues. A better way to address concerns about conflicts of interest is to demonstrably strengthen compliance procedures, reporting, and oversight.

Oversight and Compliance Evaluation by Fund Independent Directors

A better approach than banning side-by-side management of mutual funds and hedge funds is to require mutual fund directors to review and to approve stringent procedures to address conflicts of interest and to review the adviser's performance under those procedures. As mentioned earlier, at Vanguard the funds' independent directors monitor the independent advisory firms that manage money on behalf of the Vanguard funds. Our approach involves careful screening and selection, close supervision and evaluation of each firm's compliance policies and codes of ethics, and continuous review of its performance under those policies. We believe that advisers should be required to demonstrate to mutual fund boards that they have suc-

[5] Thomas P. Lemke & Gerald T. Lins, Regulation of Investment Advisers, at 2–34 (1999).

cessfully followed all procedures and, when appropriate, to inform the Board how the firm's procedures can be improved.

While mutual fund directors have long been charged with overseeing the performance and compliance of the fund's adviser, due to recent events, the Congress and the regulators have demanded more specific protections. As mentioned earlier, the SEC recently strengthened the position of fund directors in this regard by requiring that every mutual fund have a chief compliance officer reporting directly to the directors.[6] Each investment adviser must now have written policies and procedures, administered by its own chief compliance officer. These policies and procedures must address a number of issues, including allocation of trades among multiple clients. The fund boards must approve the policies and procedures of their advisers, and funds must oversee the performance of their advisers under these procedures. This new regulation makes mandatory what "best practice" investment firms have long required.

In addition, to the extent that fund directors require special experts to assist with their analysis of an adviser's performance, the SEC has recently proposed that mutual funds be required to explicitly authorize their independent directors to hire employees or other experts to help them fulfill their fiduciary duties.[7] We support this authority for independent directors (the independent directors of Vanguard funds have long had this authority) and hope that this aspect of the proposal is adopted in the final rule.

We believe that the combined effect of enhanced compliance obligations and additional support for independent directors will sufficiently protect investors from potential conflicts of interest present in the side-by-side management of mutual funds and hedge funds, as well as other investment accounts. In our view, this approach will benefit mutual fund investors and protect their interests at the same time. Accordingly, we believe that imposing an outright ban on the management of mutual funds and hedge funds is a drastic solution that does not appear to be necessary at this time, particularly in light of the SEC's recent adoption of more stringent compliance requirements for funds and advisers. To do so could well deprive mutual fund shareholders of the widest available universe of investment management talent—surely an unintended but severe consequence that should be avoided.

Thank you. We appreciate the opportunity to testify before the Committee on issues of importance to mutual fund investors.

Appendix

Management of Multiple Accounts Compliance Policies and Procedures

In Vanguard's experience, investment advisory firms have developed very effective policies and procedures to address the conflict of interest potentially present to an advisory firm or its personnel managing simultaneously mutual fund and other accounts, including the accounts of hedge funds. Those policies and procedures are typically and appropriately tailored to reflect an advisory firm's business operations and other specific characteristics. Vanguard believes that acknowledging "one-size-does-not-fit-all" is crucial to the development of workable and effective compliance procedures in the area of joint management. In particular, policies may differ for equity and fixed-income securities. Nonetheless, in Vanguard's view, certain types of compliance procedures and policies having core elements can be effective in dealing with the conflicts present in joint management of hedge funds and mutual funds. The policies and the procedures adopted for this purpose by firms Vanguard has hired fall into three categories: Procedures, both general and specific, for the allocation of securities among different clients; specialized allocation procedures for securities offered through public offerings and other limited offerings; and oversight mechanisms. Examples of the three categories of policies and procedures follow bellow:

Allocation Policies and Procedures

- One way in which investment advisory firms seek to address the potential that an individual portfolio manager responsible for managing hedge fund and mutual fund accounts could favor the hedge fund in allocating securities positions is by adopting specific policies and procedures that require orders for the purchase or sale of the same securities on behalf of multiple clients made on the same day to be aggregated. The central elements of these policies and procedures include:

[6] SEC Rel. No. IA–2204, "Final Rule: Compliance Programs of Investment Companies and Investment Advisers" (December 17, 2003).

[7] SEC Rel. No. IC–26323, "Proposed Rule: Investment Company Governance" (January 15, 2004).

—assigning the same price per securities to all clients participating in the aggregated trade, even if multiple trades are needed to fulfill the entire aggregated order;
—executing trades in accordance with a defined and objective rotation system in which all clients participate on the same basis;
—distributing costs among clients participating in the aggregated trade on a proportionate basis;
—allocating trades at, or immediately after, execution, and entering trades into client accounts promptly after execution and in accordance with the allocation policy; and
—in cases when the supply of securities is insufficient and the full amount of an aggregated trade cannot be filled, allocating on a proportionate basis to the original order or in some other objective manner that is consistently applied.

- A second general way in which an investment advisory firm seeks to deal with allocation of securities when managing mutual funds and hedge funds is by only aggregating a purchase or sale order if the aggregated order is in the best interests of each individual client participating in the order and consistent with the firm's best execution policies.
- A third general way of addressing joint management conflicts by an investment advisory firm with a trading department is by having the trading department aggregate orders in the same securities, even when the orders are originated by different portfolio managers, if aggregation provides clients with better, cheaper, and more efficient execution.
- Other specific policies and procedures Vanguard has observed that an investment advisory firm adopts in light of its business operations and other factors, in seeking to ensure that mutual fund clients are not disadvantaged by the firm's joint management activities include some of the following:

—executing at the same time all the transactions undertaken by a portfolio manager employed by the firm in the same securities during the day;
—requiring consistent trading activity among all funds having similar investment strategies, such as mandating that transactions on behalf of 11 mutual funds be entered by a portfolio manager when the portfolio manager has entered into a transaction for a hedge fund that is deemed suitable for the mutual fund;
—prohibiting a portfolio manager from maintaining different positions in the same securities on behalf of mutual funds and hedge funds that generally follow the same principal investment strategy;
—allowing a portfolio manager to undertake a securities transaction for one client while not contemporaneously entering into the same transaction for other clients, only if the portfolio manager determines and documents that the securities are or the transaction is not appropriate for the other clients;
—precluding a portfolio manager from purchasing securities for a mutual fund that have been sold recently by a hedge fund managed by the same manager, unless the manager obtains approval for the transaction from the investment advisory firm's chief investment officer or a compliance officer;
—prohibiting a portfolio manager from assuming a long position in equity securities on behalf of one client while simultaneously selling short the same securities on behalf of another client;
—establishing an order of trade execution priority for short and long transactions, giving general preference to long transactions;
—separating hedge fund short sales from mutual fund sale orders when they involve the same securities, and assigning trade execution priority on the basis of the time each of these transaction requests was received by the investment advisory firm's trading desk;
—prohibiting cross trades between the accounts of hedge funds and any other client;
—limiting cross trades between or among client accounts to liquid securities for which market quotations are readily available;
—requiring that the price used for cross transactions be the same as the last independent trade on a recognized market, and that the transactions conform to the investment advisory firm's overall trading policies and regulations; and
—restricting cross trades among specific types of accounts, such as trades involving accounts of employee benefit plans subject to the requirements of the Employee Retirement Income Security Act of 1974, as amended.

Allocation of Initial Public Offerings Securities and Other Limited Issues

- Vanguard has observed many investment advisory firms that seek to address the conflicts of interest presented by simultaneous management of hedge funds and mutual assets by adopting specialized rules covering securities purchased through initial public offerings and other limited issues. Misallocation of IPO securities has been at the center of a number of Securities and Exchange Commission enforcement cases. In some of these cases, hedge funds, but not other clients, were allocated IPO securities believed by an investment advisory firm to have the potential for strong returns. In seeking to preclude such inappropriate allocations, advisory firms, in Vanguard's experience, have adopted some or all of the following policies and procedures:
  - —apportioning IPO securities and other securities available through limited offerings according to equitable, predetermined rules, such as for example, by apportioning securities to all clients on a proportionate basis when the supply of a particular securities position is insufficient to satisfy all clients;
  - —predetermining clients that are eligible for securities offered through specific types of IPOs;
  - —dividing IPOs into categories according to size and to investment strategies furthered by holding the securities offered through the IPOs, and allocating IPO securities among all clients that have similar investment strategies on the basis of market capitalization of the issuers of the securities; and
  - —prohibiting portfolio managers and other fund personnel from participating in IPOs through hedge funds.

Oversight of Policies and Procedures

- Vanguard believes that crucial to effective compliance is a strong oversight of policies and procedures adopted to protect the interests of clients. Each investment advisory firm used by Vanguard must demonstrate it has established review processes and has retained the necessary oversight personnel to supervise trading activities and to ensure compliance with Vanguard's and the investment advisory firm's policies. An investment advisory firm should, as a starting point, have a compliance officer to review trading activity, monitor compliance with policies, and intervene in situations in which conflicts of interest are apparent. Other specific oversight mechanisms that Vanguard has observed investment advisory firms adopt with respect to joint management allocation policies and procedures include some or all of the following:
  - —investment advisory firm personnel regularly on a periodic basis reviewing client transactions to identify potential conflicts of interest;
  - —an investment advisory firm's portfolio managers, traders and/or compliance employees bringing transactions to the attention of a supervisor and/or an executive officer of the firm for closer review;
  - —investment advisory firm compliance personnel reviewing representative samples of client transactions to assess overall compliance with the firm's trade allocation policies and procedures and to ensure fairness and equity in the operation of the firm's trading systems;
  - —an investment advisory firm's allowing for exceptions to the firm's policies and procedures only if the exceptions are properly documented and approved by a compliance officer employed by the firm;
  - —investment advisory firm personnel preparing and retaining separate documentation for each client participating in an aggregated order;
  - —investment advisory firm compliance officers' periodically reviewing past trade allocations to determine whether any client was systematically disadvantaged as a result of aggregated transactions;
  - —investment advisory firm compliance officers' reviewing portfolio manager determinations that trade aggregation provides all clients with the opportunity to achieve more favorable execution;
  - —an investment advisory firm's identifying instances in which a portfolio manager has deviated from the firm's allocation policy, and if so, whether the portfolio manager has identified a legitimate reason for the allocation;
  - —an investment advisory firm's requiring portfolio managers to document the reasons for entering into different or opposite positions on behalf of multiple clients, and requiring a compliance officer of the firm to review portfolio manager explanations at least every quarter;
  - —investment advisory firm personnel automatically time-stamping, at multiple stages of transactions, all records of transactions undertaken on behalf of all clients;

—an investment advisory firm's allowing short selling of securities by a hedge fund that are held long by a mutual fund advised by the portfolio manager of the hedge fund only if the manager receives approval for the short sale from the firm's compliance department and if this policy is properly disclosed to all clients involved, including the mutual fund;
—an investment advisory firm's permitting cross trades subject to the condition that they be monitored by compliance officials charged with identifying trading patterns of cross trades between or among mutual funds and hedge funds;
—investment advisory firm compliance personnel simultaneously reviewing hedge fund trading and mutual fund trading;
—an investment advisory firm's compliance personnel reviewing daily hedge fund transaction reports to identify transactions executed on behalf of hedge funds by portfolio managers who executed transactions on behalf of mutual funds within 7 days before or after the hedge fund transactions;
—an investment advisory firm's requiring portfolio managers to sign quarterly trading reviews for each hedge fund and mutual fund they manage, certifying that all trading was in compliance with each fund's investment strategy and that all clients were treated fairly and equally;
—an investment advisory firm's requiring portfolio managers to explain to oversight officials the investment rationale for proposed transactions on behalf of hedge funds that appear to be inconsistent with transactions undertaken on behalf of mutual funds;
—an investment advisory firm's establishing hedge fund review and oversight groups to provide specific fiduciary oversight for hedge fund transactions and to ensure that policies and procedures relating to hedge fund management are followed;
—an investment advisory firm's reviewing IPO allocation procedures and allocations at least annually;
—an investment advisory firm's having its compliance officer or an investment committee review prospective allocation of IPO securities prior to execution of the transaction in the securities;
—an investment advisory firm's requiring written explanations of the investment rationale underlying hedge fund transactions;
—an investment advisory firm's disclosing the potential conflicts of interest presented by simultaneous management of client accounts in the appropriate regulatory forms and offering materials; and
—an investment advisory firm's reviewing and updating compliance policies and procedures and related disclosures to ensure accurate representation to all actual and prospective clients of potential conflicts of interest.

PREPARED STATEMENT OF ANN E. BERGIN

MANAGING DIRECTOR, NATIONAL SECURITIES CLEARING CORPORATION

MARCH 2, 2004

Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee, I appreciate the opportunity to discuss the SEC's proposal to amend Rule 22c–1 of the Investment Company Act of 1940. With your permission, I would like to have two documents previously provided to Committee staff included in the record: NSCC's February 6 comment letter to the SEC on the proposed amendment and a brochure that describes how our fund processing system, which is called Fund/SERV®, works.

For those of you unfamiliar with our organization, NSCC and its affiliated clearing agencies play a significant role in supporting the U.S. financial markets. We provide post-trade clearance, settlement and information services for equities, corporate and municipal bonds, mutual funds, and other securities.

Current regulation allows a mutual fund order to be priced according to the time it is received by an intermediary—a broker-dealer or plan administrator, for example. Therefore, an order received by an intermediary by 4 p.m. is eligible for today's price, even if it is transmitted to the fund at a later time.

I have been asked to speak about that aspect of the SEC's proposal providing that an order to purchase or redeem shares in a mutual fund would have to be received by a fund, its transfer agent or a registered clearing agency by 4 p.m. in order to receive the current day's price.

The NSCC is a clearing agency, registered with the SEC under the Securities Exchange Act of 1934. As such, we are subject to comprehensive regulation and oversight by the SEC. We are currently the only registered clearing agency providing services to the mutual funds industry. In the past year we have been called upon to take an active part in several industry and regulatory initiatives involving mutual fund processing, including the NASD/Industry Task Force on Breakpoints and the NASD Omnibus Account Task Force.

NSCC is owned by our users—broker-dealers, banks, mutual fund companies, and other financial service firms, and we are governed by a user-representative board of directors. The clearance, settlement, and information services NSCC provides are developed at the request of our users. Our revenues are generated by the fees that are paid by our users; and, to the extent those revenues exceed our costs, the excess revenues are refunded to them.

NSCC's participation in the mutual fund industry began nearly 20 years ago, in 1986, at the request of market participants.

Our Fund/SERV system provides a standardized, automated process for distribution intermediaries to transmit purchase, redemption, and exchange orders through a single process and a single communications link. Like all of the NSCC's fund services, participation in Fund/SERV is optional, but it has become the industry standard for processing fund and defined contribution transactions at the wholesale level. We estimate that today Fund/SERV processes the vast majority of these wholesale transactions. Last year, Fund/SERV handled 87 million fund transactions—roughly 350,000 a day—with a value of $1.54 trillion. About 650 mutual fund companies and more than 430 intermediaries, offering 30,000 different funds, use Fund/SERV today.

Fund/SERV has greatly reduced operational errors, lowered the cost of processing, established standards and introduced order into the marketplace. By acting as a central conduit, Fund/SERV allows intermediaries to offer investors a much broader range of funds than before at a much lower cost.

Allow me to walk you through how a typical mutual fund trade is processed. In my example, once an individual investor advises his broker-dealer that he wishes to purchase a particular mutual fund, the broker-dealer enters the order into its system. That system transmits order files electronically to Fund/SERV periodically throughout the day. And through Fund/SERV the orders are directed to the appropriate fund company. The fund company either confirms or rejects the orders and then transmits that information back to the broker-dealer through Fund/SERV.

As long as the broker-dealer is in receipt of the order by 4 p.m., under today's rules the order is given that day's price, regardless of what time the trade is processed through Fund/SERV. Fund/SERV receives order files over a 22-hour period each business day from 2 a.m. until midnight, and many of these files are received and then redirected to the fund companies between 5 and 8 p.m.

Under the proposed regulation, even if the order is received by the broker-dealer before 4 p.m., unless the broker-dealer is able to retransmit the order to NSCC (as the registered clearing agency), the fund or its transfer agent by 4 p.m., the purchase will not be made at today's price.

We anticipate that this would dramatically change the current trade flow, and result in a significant increase in the number of trades received at NSCC in the half-hour just prior to 4 p.m. We have done some preliminary analysis and believe that our current systems capacity is sufficient to handle the concentration of orders within that shortened time frame. However, we will need to make technological enhancements to some of our services. To date, we have identified three such major enhancements.

One: We would need to create a uniform methodology to record the time of receipt of each order file at NSCC. Subsequently, each order within that file would be coded with that time of receipt before transmission to the fund.

Two: Our system would need to recognize the elements of a very complete and valid order, so that the order is final and unalterable as of 4 p.m. Those elements would include the order type, that is, a purchase, redemption, or exchange; the name of the fund; and either the specific number of shares, or the dollar amount of the order.

Three: We would need to build functionality to allow intermediaries to communicate additional information about a valid order after 4 p.m. This could include information not known prior to 4 p.m., as long as this information does not alter any of the essential elements of the order—for example, the breakpoint discount to which an investor is entitled or the purchase specifics of an exchange transaction.

We believe we can complete these enhancements within the 1 year following the adoption of the amendment, as was proposed by the SEC, at an estimated cost of approximately $5 million. This estimate is limited to NSCC's costs, which, as I indi-

cated earlier, would be funded by our users, and does not include costs that would be directly incurred by our users in making corresponding changes to their own systems, as many of them would have to do. Some in the industry also believe that additional time would be needed to ensure rigorous testing of these changes.

NSCC does recognize that migrating the time-stamping function from the intermediary to NSCC will impose some limitations on the flexibility currently afforded to all mutual fund investors. We feel strongly, however, that applying a hard 4 p.m. close at NSCC is far better for investors than applying a hard 4 p.m. close only at the fund or its transfer agent.

In our comment letter to the SEC, we advised that the flexibility of the current system could be retained through the implementation of the alternative solution that was proposed for comment by the SEC. That solution would leave the responsibility for time-stamping at the intermediary level—with the addition of new safeguards to prevent late trading abuses.

Whatever the Commission's final determination is, NSCC is committed to working with the industry to facilitate compliance with the new regulations.

I will be pleased to answer any questions.

NATIONAL SECURITIES CLEARING CORPORATION
55 WATER STREET
NEW YORK, NEW YORK 10041

February 6, 2004

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20459-0609

Re: File No. S7-27-03, Proposed Amendments
to Rules Governing Pricing of Mutual Fund Shares

Dear Mr. Katz:

National Securities Clearing Corporation ("NSCC") appreciates the opportunity to comment on the proposal by the Securities and Exchange Commission (the "Commission") to amend Rule 22c-1 under the Investment Company Act of 1940 (the "Investment Company Act").[1] NSCC is a clearing agency registered with the Commission under Section 17A of the Securities Exchange Act of 1934 (the "Exchange Act").

As is discussed more fully below, NSCC is prepared to modify its systems to incorporate into its Fund/SERV®[2] system a centralized "time-stamping" capability as contemplated in the proposed amendments to Rule 22c-1. NSCC agrees that, if the Commission considers it necessary to require the use of a more centralized capability to validate the time of receipt of a mutual fund order for purposes of determining the net asset value at which it should be completed, it is appropriate to have that capability incorporated into Fund/SERV as the most effective and least disruptive approach to this requirement. NSCC also recognizes, however, that moving to a centralized "time-stamping" approach will impose some limitations on the flexibility of all investors in mutual funds, and will eliminate the ability to conduct certain transactions on a same-day basis – negative effects that could be eliminated through the implementation of reinforced approaches to time-stamping at the intermediary level. We recognize that the Commission will have to judge whether those adverse impacts on the broad population of investors in mutual funds are outweighed by the benefits of the proposed amendments. NSCC is prepared to work with the Commission, mutual fund companies and the investment community to implement the Commission's determinations as to the necessary solutions to this industry problem.

1 Investment Company Act Release No. 26288 (December 11, 2003), 68 Fed. Reg. 70388 (December 17, 2003) (the "proposing release").

2 Fund/SERV is a registered trademark of The Depository Trust & Clearing Corporation.

NSCC's Role as the Mutual Fund Clearing House

NSCC provides centralized clearance, settlement and information services for a substantial majority of U.S. inter-broker trades in equity securities, corporate and municipal bonds, exchange-traded funds and unit investment trust shares. In addition, NSCC offers centralized information and settlement services for mutual fund and insurance and annuity transactions by linking mutual funds and insurance carriers with broker-dealers, banks and other distributors of mutual funds and insurance products.

As indicated in the proposing release, NSCC is the only registered clearing agency that provides an automated system for processing mutual fund orders, Fund/SERV. NSCC's Fund/SERV system receives order information from broker-dealers, banks, 401(k) plan administrators and other NSCC participants and transmits the information to the appropriate fund. The fund may confirm or reject each order and send the corresponding order confirmation or rejection data through Fund/SERV to the appropriate broker-dealer or other NSCC participant[3].

NSCC's Fund/SERV system provides cost-effective and efficient solutions to the mutual fund marketplace by centralizing and automating the communication of data in the mutual fund order clearance and settlement process and by providing standardized formats for mutual fund order data. NSCC is an industry utility which is owned and governed by the broker-dealers, banks, mutual funds and other financial institutions which use its services[4]. It does not pay dividends on its capital stock and it rebates excess revenues to its users. In 2003, NSCC processed over 87 million fund transactions at a value of $1.54 trillion. NSCC processed a daily average of 345,000 fund transactions at a value of $6.1 billion in 2003. Daily mutual fund transaction volume reached a peak of 661,847 transactions processed through Fund/SERV on January 20, 2004.

Overview

The Commission's proposed amendments to Rule 22c-1 provide that an order to purchase or redeem shares in a mutual fund (a "mutual fund order") would receive the current day's price only if the mutual fund, its designated transfer agent or a registered clearing agency

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3 Use of Fund/SERV is limited to NSCC members, which are typically broker-dealers, banks, third-party administrators, mutual funds, advisors and distributors of mutual funds. Mutual funds and their distributors may (and typically do) direct receipt of orders from NSCC to their transfer agents. Qualification for NSCC membership is set forth in NSCC's Rules, which are available on NSCC's website: www.nscc.com. As a self-regulatory organization within the meaning of the Exchange Act, NSCC's rules of operation are subject to approval by the Commission (see 15 U.S.C. 78c(a)(26), 78(s)(b)).

4 NSCC is a wholly-owned subsidiary of The Depository Trust & Clearing Corporation, which in turn, is owned by its principal users – major banks, broker-dealers, mutual fund firms and other companies within the financial services industry. DTCC's Board of Directors is made up of 21 directors who also serve as directors of NSCC.

(an "authorized time-stamping organization") receives the order by the time that the mutual fund has established for calculating its net asset value (e.g., 4:00 p.m. Eastern time)[5].

If the proposed amendments are adopted, NSCC agrees with the Commission that registered clearing agencies should be included among the entities authorized to time-stamp mutual fund orders for purposes of establishing the time of receipt of a mutual fund order.[6] NSCC can, and is willing to, perform such a role. As a registered clearing agency, NSCC is subject to comprehensive regulation and oversight by the SEC and is neutral with respect to which price a fund assigns to a mutual fund order. In addition, including registered clearing agencies among authorized time-stamping organizations would permit fund intermediaries to continue processing mutual fund orders through Fund/SERV, and thus continue the many important benefits NSCC brings to the mutual fund marketplace as set forth above.

The Commission recognizes in the proposing release that the proposed rule change, if adopted, will require substantial changes in the way intermediaries process mutual fund orders, and will necessarily disadvantage certain transactions effected through certain intermediaries. In this letter, NSCC addresses such processing changes and disadvantaged transactions as they relate to transactions which are currently processed through Fund/SERV.

NSCC currently processes mutual fund orders over a 22-hour period each business day. Most orders are received and transmitted in batch files with NSCC running 29 batch cycles in each 22-hour day. Approximately 27% of the total daily orders are received by NSCC between 8:00 a.m. and 4:00 p.m. The other 73% are received outside of these hours, after they have been reviewed by the intermediary (e.g., a bank, broker-dealer or 401(k) plan administrator) and processed through their internal systems prior to transmission to NSCC. Intermediaries will necessarily have to change their processing flows significantly, and some may have to impose an earlier cut-off time on receipt of orders from their customers, in order to transmit all such orders to NSCC by 4:00 p.m.

In addition, certain transactions such as portfolio rebalancing transactions (explained below) are currently calculated and processed at the intermediary based on the current day's price, and subsequently transmitted through Fund/SERV in post-4:00 p.m. files. For several reasons, it is impossible to complete processing and transmission of certain of these transactions as completed orders prior to 4:00 p.m. Upon the implementation of the proposed amendments, therefore, these transactions will no longer be eligible to receive same-day pricing.

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5 Although some funds use a different time for establishing net asset value, we assume for purposes of this letter that the funds price at 4:00 p.m. and hence will establish 4:00 p.m. receipt as the "close" or "cut-off" time for an order to be assigned that day's price. For funds which price at a different time during the day, that particular time of the day would be the relevant time of receipt for these purposes.

6 NSCC notes that being designated as an authorized time-stamping organization would be consistent with NSCC's obligations under the Exchange Act to facilitate the prompt and accurate clearance and settlement of securities transactions and to protect investors and the public interest. See Exchange Act § 17A(b)(3)(F), 15 U.S.C. § 78q-1(b)(3)(F).

Comments on the Alternative Proposal

The Commission included in the proposing release a request for comments on an alternative proposal designed to prevent the manipulative late trading of mutual fund shares. Under this alternative, fund intermediaries (including, NSCC assumes, certain fund intermediaries which are not registered with or supervised by the Commission) would be required to adopt certain safeguards against late trading in order to be eligible to submit orders to designated transfer agents or clearing agencies after 4:00 p.m. These measures would include, for example, electronic or physical time-stamping of mutual fund orders by fund intermediaries in a manner that could not be altered or discarded once the mutual fund order is entered into the trading system.

Were the Commission to adopt the alternative proposal, NSCC would be prepared to work with the Commission and the industry to adopt appropriate safeguards in its Fund/SERV system in order to facilitate proper pricing with respect to mutual fund orders, such as enhanced electronic audit trails for mutual fund orders.

NSCC believes that, if the Commission adopts the alternative proposal, it should include all types of fund intermediaries that currently process after 4:00 p.m., in order to preserve the efficiencies of the current processing systems.

Implementation of Proposed Rule by NSCC

Establishing Time of Receipt

If the proposed rule is adopted, NSCC would establish a uniform methodology for determining when a mutual fund order would be deemed to be received by NSCC (i.e., as a technical matter, at what point during NSCC's automated processing a mutual fund order would be electronically time-stamped as received), based upon the earliest point of receipt at which the order is not susceptible to alteration by its sender.

As indicated above, most participants submit orders to NSCC in transmissions of batch files which contain multiple orders. NSCC anticipates that it would time stamp each file upon completion of a transmission, and subsequently include the time stamp from the file on each order within the file. Each order which is subsequently transmitted to the fund by NSCC would therefore bear the time stamp indicating the time that the order was received by NSCC.

As recognized in the proposing release, NSCC would have additional time after the time-stamping of the mutual fund orders to complete the processing of orders that were received earlier in the day, and such processing could be completed after the 4:00 p.m. close.[7] NSCC believes that the distinction between the requirement to **confirm receipt** of a mutual fund

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7 See proposing release, 68 Fed. Reg. at 70391 n.28.

order ***by*** 4:00 p.m. (for purposes of the forward pricing requirement of the proposed rule) and the ability of NSCC to **process** such mutual fund order ***after*** 4:00 p.m. (for purposes of the prompt and orderly clearance and settlement of the order) is critical to NSCC's ability to accommodate a 4:00 p.m. close without undue disruption to the market place. Completion of order processing by 4:00 p.m. at NSCC would require substantially increased computer system capacity and would require NSCC to establish a significantly earlier cut-off time for receipt by NSCC. Imposition of an earlier cut-off time at NSCC could further impact the ability of firms using Fund/SERV to offer same-day pricing to their customers.

The Definition of "Order": Subsequent Provision of Ancillary Information

The term "order" is defined in the proposed rule as "a direction to purchase or redeem a specific number of fund shares or an indeterminate number of fund shares at a specific value."[8] An "order" for mutual fund shares would be complete for purposes of the forward pricing requirement when it contains a specified fund security, and a specific number of shares or a specific dollar value. An order would be deemed irrevocable as of the next pricing time after it is received by the mutual fund, its designated transfer agent or a registered clearing agency.

NSCC would, therefore, deem a communication to be an order for purposes of establishing time of receipt if the communication contained a mutual fund security identifier, and identified a specific number of shares or a dollar amount subject to a purchase or redemption.

Intermediaries currently review and process orders in their internal systems to calculate or determine other elements of the trade. For example, calculation of the appropriate front-end load sales discount ("breakpoint") to which an investor is entitled may be based upon the rights of accumulation, letter of intent or other applicable fund rules. An intermediary's submission after the 4:00 p.m. close of this ancillary order information for a previously submitted order would seem to be consistent with the proposed rule.

Accordingly, NSCC suggests that the Commission include language in the release accompanying the final version of the rule indicating that fund intermediaries may supplement mutual fund orders with certain ancillary information after receipt of the order by a mutual fund, its designated transfer agent or a registered clearing agency, provided that the ancillary information would not have the effect of canceling a mutual fund order or modifying the identity of the fund or the number of shares or the dollar value contained in the order after the time that the fund has established for calculating net asset value.

8 See proposing release, 68 Fed. Reg. at 70398. NSCC believes that it is implicit in this definition that the fund securities that are the subject of the order also be identified.

Exchange Transactions

The definition of "order" in the proposed rule accommodates exchange transactions, by defining an order to include the purchase of an unspecified number or value of shares of a fund "...using the proceeds of a contemporaneous order to redeem a specific number of shares of another fund (or exchange)..." Currently, NSCC supports a transaction type which accommodates exchanges within a fund family at the current day's price. NSCC anticipates that it would expand this transaction type to identify exchanges between or among funds in different fund families, for purposes of allowing the fund on the purchase side of the exchange transaction to identify the purchase order as "linked" to the redemption side, and hence entitled to same-day pricing under the proposed rule. NSCC could also expand its exchange transaction type to identify a mutual fund purchase order processed through Fund/SERV as linked to a contemporaneous redemption order of an investment which is not a mutual fund or otherwise not processed through NSCC's Fund/SERV system. This would allow the fund on the purchase side of the exchange to recognize the purchase order as the subject of an exchange which is entitled to same-day pricing under the proposed rule.[9]

Portfolio Rebalancing Transactions

In a portfolio rebalance transaction, an investor instructs that his or her holdings be reallocated among multiple investment options according to the total value of the portfolio, allocating a percentage of the total value to each investment option. A portfolio rebalance transaction requires complex calculations based on net asset values prior to establishing what action needs to be taken (i.e., whether any specific investment option will be the subject of a purchase or a redemption order).

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9 This assumes the final rule permits mutual fund purchase orders resulting from an exchange transaction to receive same-day pricing when the proceeds are derived from the redemption or sale of a non-mutual fund investment.

NSCC notes that it is not possible for NSCC to build a functionality that could translate portfolio rebalancing transactions into orders eligible for same day pricing under the proposed rule, due to the very large number of unknown variables attendant to a rebalancing order and the nature of the information that is required to effect an investor's rebalancing instruction[10].

Preliminary Estimates of Required Time and Costs Associated with System Changes Necessary to Accommodate the Commission's Proposal

NSCC would need to make significant changes to a number of its mutual funds software applications to implement the relevant provisions of the final rule. NSCC would also need to amend its Rules & Procedures to reflect these changes, and the changes to NSCC's Rules & Procedures would have to be filed with and approved by the Commission pursuant to Section 19(b) of the Exchange Act.

Changes to NSCC's mutual fund applications would include:

- time-stamping transmissions at the earliest processing point and applying the time-stamping of the transmission to each order within a transmission;
- making all of the essential elements in an order mandatory fields;
- building a functionality for the communication of ancillary information, related to a specific order; and
- expanding the exchange transaction functionality to identify exchanges between unrelated fund families or for which the mutual fund redemption order relates to proceeds from a sale transaction outside of NSCC.

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10 For example, a rebalance order from an investor in a retirement plan which contained twelve investment choices could result in 132 possible mutual fund (or other investment) orders, any one of which could be an order to purchase or an order to redeem, depending upon that day's net asset values. In addition, some of the investment options may not be processed through NSCC's Fund/SERV system. Today, the retirement plan administrator processes the rebalance transaction data through its system, based on knowledge of the applicable plan rules and information specific to the identity of the investor, after current day fund prices have been established. The administrator then calculates the orders that have resulted from the rebalance instructions. It sends the net amount of the resultant mutual fund orders through NSCC for communication to the applicable funds, and routes order data that is not processed at NSCC to other systems. An analogous process is used by broker-dealers and other intermediaries when processing portfolio rebalancing instructions for retail investors. We are advised that some retail firms rebalance portfolios based on the previous day's net asset values of the various investments, but that same-day pricing is typically applied to an investor's rebalancing or reallocation instruction in a retirement plan.

NSCC participants would be required to make corresponding changes in their computer systems, and some may decide to change to "real-time" transmissions or to transmit files to NSCC using increased bandwidth in order to allow them to transmit larger volumes of data to NSCC shortly before the 4:00 p.m. close.

Due to the magnitude of the changes, NSCC would require a substantial period to design, program and test its systems changes both internally and with its participants. NSCC would also plan to run the revised system in production mode prior to the effectiveness of the final regulations. This would allow NSCC's members to assess whether their transmission procedures with NSCC would be sufficient to permit them to meet the 4:00 p.m. close while still conforming with their service commitments to their customers.

Due to the magnitude of the change in general, the exact extent of the software application changes required cannot be assessed until a final rule is adopted. Further, changes in the behaviors of NSCC's participants in light of the parameters of the final rule may require additional modifications later on. NSCC has worked closely with the industry over the last few months to prepare a preliminary assessment of the changes that would likely be required under the parameters of the rule as currently proposed. NSCC would continue to work closely with the Commission and the industry while modifying its systems to accommodate the parameters of the final rule.

Based on its preliminary assessments, NSCC believes that its system can be modified to accommodate the requirements of the proposed rule within the suggested one-year transition period, and that the full one-year transition period is necessary in light of the nature and extent of the changes that will be required and the need for careful and extensive testing of those changes. NSCC requests, however, that it be permitted to consult with the Commission after adoption of a final rule and throughout the transition period, with the possibility of requesting an extension or phased implementation schedule should unforeseen circumstances occur.

We note, also, that if additional, unrelated changes are required in respect of mutual fund processing, this could further impact the time required by NSCC and its members to implement these changes. We are aware that the Commission has other initiatives underway in respect of the consideration of rules to help prevent market timing and in respect of omnibus trading. It is not possible at this time to factor in any additional software or processing changes that may be required as a result of those initiatives, nor how the timeframe for implementation permitted by the Commission in those instances could impact completion of the processing changes required to implement this proposed rule.

NSCC notes that it is difficult to estimate with any certainty at this point its costs for modifying its systems to facilitate a 4:00 p.m. close, for the reasons stated above. Based on its preliminary assessment and subject to this caveat, NSCC estimates that its costs for making the necessary system changes could be in excess of $5 million. In addition, participants will incur their own costs in adopting corresponding changes to their systems, as required.

Because NSCC is operated as a not-for-profit industry utility, its costs are passed on to its users. In this case, we anticipate that the costs of these changes would be borne by the fund intermediaries and funds which use Fund/SERV and NSCC's other mutual fund services.

Recommendations Regarding the Emergency Exception

The proposed rule would provide an exception from the forward pricing requirement if there were an emergency that would prevent a designated transfer agent or a registered clearing agency from receiving mutual fund orders by 4:00 p.m. The chief executive officer ("CEO") of the designated transfer agent or the registered clearing agency would have to notify the mutual fund of such emergency. The preamble of the proposing release indicates that the emergency exception is intended to cover situations that are external to a broker-dealer, designated transfer agent or registered clearing agency, such as a power failure, hurricane or other natural disaster.[11]

NSCC would like to offer two recommendations with respect to the proposed emergency exception.

First, NSCC believes that, given that NSCC processes transactions with over 600 mutual funds, it clearly would be impractical for its CEO to provide notice to each of these mutual funds in the case of an emergency, and that the CEO may not be available at the time that the notice must be given. Accordingly, NSCC recommends that the Commission include language in the final version of the proposed rule that would permit the CEO of a designated transfer agent or a registered clearing agency to designate one or more other individuals to assume the CEO's obligations under the emergency exception to the forward pricing requirement. In addition, given the number of funds with which NSCC interacts, NSCC recommends that the language in the final rule give a registered clearing agency discretion in the method in which it communicates the notice to the fund (e.g., system broadcast, e-mail or other method of communication reasonably capable of receipt by the fund).

Second, NSCC believes that the circumstances contemplated in the preamble of the proposing release that would constitute an emergency are too narrow in the case of a registered clearing agency. NSCC believes that this exception should include significant system outages and delays that may impact the clearing agency's orderly receipt and time-stamping of mutual fund orders by the 4:00 p.m. close, perhaps by reference to the sorts of significant outages and delays that a clearing agency is required to report to the Commission under the Commission's Automation Review Policy ("ARP").

Outages and delays in a clearing agency system cannot reasonably be anticipated by market participants and thus do not present a realistic opportunity for manipulative late trading. Such outages or delays would be attributable to circumstances beyond the control of any

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11 See proposing release at 70391 n.36.

market participant and unrelated to any fraudulent trading activity. Nonetheless, such outages or delays would have the same effect on mutual fund orders as the sort of external occurrences described by the Commission in the proposing release and, given the large number of mutual fund orders that are communicated through Fund/SERV, could significantly disrupt the mutual fund marketplace.

Accordingly, NSCC recommends that the Commission indicate, in the release accompanying the final version of the proposed rule, that the emergency exception could also be invoked in the event of a significant systems outage or delay that prevents a registered clearing agency from timely receiving orders, with respect to which the registered clearing agency submits to the Commission a Systems Outage Notification pursuant to the Commission's Automation Review Policy, and the registered clearing agency's chief executive officer or designee notifies the fund of such systems outage or delay.

The Commission may also wish to consider whether a similar provision should be available, upon appropriate notice to the fund, to transfer agents and to intermediaries submitting mutual fund orders.

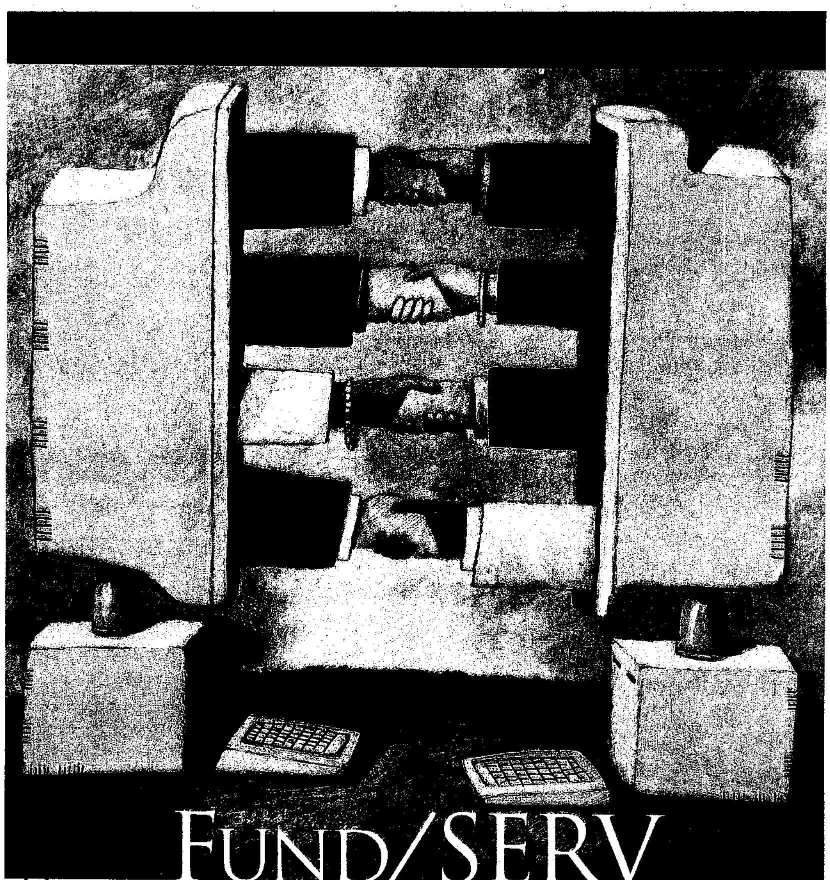
* * *

NSCC appreciates the opportunity to comment on the proposing release. Please feel free to contact Ann E. Bergin, Managing Director of NSCC at 212-855-5655, or Carol A. Jameson, Senior Counsel and Vice President of NSCC at 212-855-3213, with any questions that the Commission staff may have regarding the above comments.

Sincerely yours,

NATIONAL SECURITIES CLEARING CORPORATION

By: **/s/ Carol A. Jameson**
Carol A. Jameson
Vice President and Associate Counsel



NATIONAL SECURITIES CLEARING CORPORATION

Fund/SERV is a highly automated system that brings standardization to mutual fund transaction processing. Fund/SERV centralizes order entry, confirmation, registration and settlement of mutual fund transactions for mutual fund companies and financial services firms that distribute mutual fund shares.

RESPONDING TO THE NEEDS OF THE MUTUAL FUND INDUSTRY

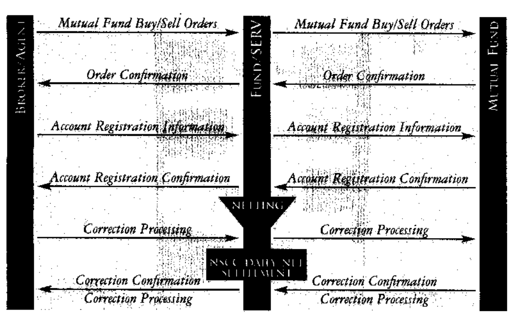
Fund/SERV was created in response to the mutual fund industry's need for an automated system to process mutual fund transactions, and to facilitate continued growth in this market.

Before Fund/SERV, manual transaction processing threatened the rapid growth of mutual funds. Financial services firms telephoned orders to fund groups, with confirmations returned by telephone, overnight mail or other means. Labor-intensive and costly settlement processing and long settlement cycles were the norm. Each fund and firm had its own

processing methods, which then had to be translated by the receiving party. Cumbersome procedures hindered the efficiency and accuracy of the process.

In response, NSCC (the clearing corporation) worked with the Investment Company Institute and the National Association of Securities Dealers, Inc. to develop an automated solution — Fund/SERV.

With Fund/SERV, the clearing corporation acts as a communications hub, receiving and distributing transaction and account registration information through computers, rather than on paper. Firms send their orders directly to the clearing corporation through their mainframe and/or PC interfaces. The clearing corporation reviews the order requests, then electronically forwards them to the appropriate mutual fund distributors for processing. Both parties are given the opportunity to make corrections over the system, making additional paperwork unnecessary.



Once the fund distributor sends an electronic message to the clearing corporation confirming acceptance of the order, the clearing corporation relays that confirmation to the financial institution, and proceeds to settle the accounts of both parties. The entire process

can be completed on the same day, next day, or in whatever cycle is appropriate for the fund.

Since Fund/SERV began operating in 1986, manual processing of mutual fund transactions has been greatly reduced. Through this automated, centralized service, hundreds of thousands of mutual fund orders, worth billions of dollars, are now processed every day.

BENEFITS OF FUND/SERV

This core processing system provides brokers, funds, banks and other financial intermediaries with exceptional flexibility in several areas:

- *Accommodates Customers' Operating Requirements* The clearing corporation's customers can use Fund/SERV to match their own processing capabilities through multi-batch or interactive communication.
- *Centralizes Settlement* In Fund/SERV, a net money settlement figure is calculated for each customer's total mutual fund activity, every day, and one payment is made to or from the clearing corporation.

- *Supports Multiple Settlement Cycles and Payment Methods* This includes "Same Day," "Next Day" and T+3 Settlement cycles. All money settlements are in Fed Funds.

- *Access is Unlimited* An open format allows orders to be entered throughout the processing day.

- *Offers Superior Processing Capabilities* Financial firms can take advantage of several convenient functions, including correcting orders before and after settlement.

- *Reduces Costs* Automated and standardized procedures make processing more efficient, thereby reducing operating costs and making it easier to facilitate volume growth.

- *Facilitates Underwritings and Tender Offers* Fund/SERV supports the special processing needs of these complex and high-volume transactions.

MAJOR FEATURES OF FUND/SERV

FLEXIBILITY

Fund/SERV's unique database design provides optimal flexibility to manage the processing of mutual fund transactions.

- *Unique Customer Profiles* These profiles allow mutual fund companies and financial intermediaries to tailor processing requirements to meet their

operational and business needs, e.g., the terms of acceptance or rejection, processing times and transaction settlement.

Communications Capabilities Tailored to Meet Business Needs

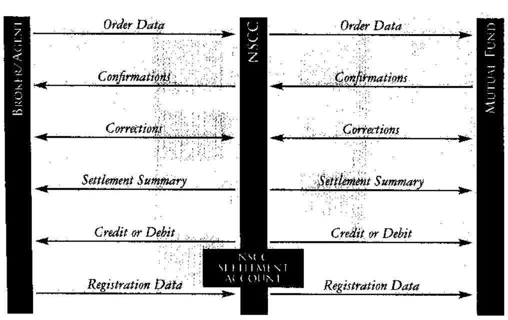
Fund/SERV can support the following communications capabilities:

- *Multiple-Batch Processing* Data on mutual fund transactions is sent and received several times a day.
- *Interactive Transaction Processing* Fund/SERV transactions are processed as they are received.

Processing Efficiencies for Funds and Financial Firms

Fund/SERV provides the most flexible and automated transaction processing possible. Customers can take advantage of such features as:

- Broadened correction capabilities, e.g., pre- and post-settlement
- Exchanges within a fund family
- Transaction tracking via unique control numbers



OTHER VALUABLE FEATURES

Cash Adjustment Mutual funds and other financial institutions can make claims for, among other things, dividends, capital gains, commission billing and commission adjustments through Fund/SERV's cash adjustment feature.

Account Registration Firms can submit account registration instructions to Fund/SERV at the time of or subsequent to placing an order. Funds acknowledge, reject or delete pending registrations through the system. Following settlement, Fund/SERV issues reminders when registration instructions have not been received by the fund, or acknowledgments have not been received by the financial institution.

Settlement Override for 401(k) and WRAP Programs For orders resulting from 401(k) and WRAP programs, which may require a different settlement period from traditional retail orders, firms can use the Settlement Override feature of Fund/SERV. This feature allows firms to designate a settlement date for an individual order.

Alternate Settlement Cycle A separate settlement cycle can be established in advance by a firm, reflecting all trades processed for individual firms.

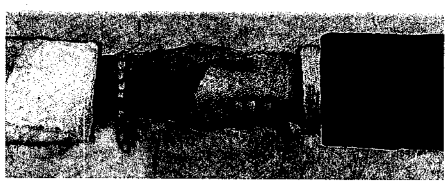
Trust Indicator A special indicator in Fund/SERV allows trusts to be identified by the fund. This allows trusts to clear and settle mutual fund transactions using gross figures.

Mutual Fund Underwritings and Tender Offers Fund/SERV adapts to the unique processing needs of underwritings and tender offers. Investment companies can take advantage of this centralized automated environment to process fund offers. The clearing corporation's Underwritings service supports IPOs, while Tender Offers supports the redemption of mutual fund shares. When marketing new securities, firms can process a large volume of orders without internally "warehousing" them or overloading their data entry staff at the end of an offering period. With Fund/SERV, firms can enter orders, then modify or cancel them during the offering period, and all the confirmed orders will settle on a specified date.

THE FUND/SERV PROCESS

The following process illustrates the steps in a typical Fund/SERV transaction:

- *Order Entry* Financial services firms can input orders from 2 A.M. until midnight. Orders that can be processed include buy, sell, exchange and "as-of" instructions.
- *Order Retrieval* Funds can retrieve orders — including buy, sell, exchange or "as-of" orders — from 2 A.M. until midnight once a day, several times a day or immediately, depending upon whether their processing is multi-batch or interactive.
- *Confirmation* Funds can confirm orders and firms can retrieve confirmations from 2 A.M. until midnight. Money market funds receive confirmation after settlement on trade date, except for liquidations, which are confirmed prior to settlement.



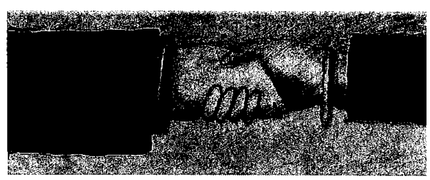
- *Correction Processing* Firms may make corrections before and after the settlement date, depending upon the fund's capabilities.
- *Settlement* Fund/SERV supports multiple settlement cycles. The settlement cycle of each transaction is defined

at the individual security level. Settlement summaries are sent to both the financial institution and the mutual fund prior to settlement.

- *Registration* Even the registration process is flexible on Fund/SERV. Once the order is sent, firms can send registration instructions any time between 2 A.M. and midnight, and funds have the option of receiving registration instructions as soon as the firm sends them, or of warehousing the instructions at the clearing corporation until settlement. For money market instruments, registration instructions must be submitted with the purchase order.

HOW YOUR FIRM CAN PARTICIPATE IN FUND/SERV

Firms can access Fund/SERV through mainframe and/or PC interfaces. A Marketing Representative can provide you with details on your options for connecting to the Mutual Fund Services.



REQUIREMENTS FOR MEMBERSHIP WITH THE CLEARING CORPORATION

The clearing corporation is committed to serving the growing needs of all its customers. To accomplish this, we have made the terms of membership flexible. Applicants are asked to satisfy reasonable requirements in order to ensure the financial integrity of the system.

FEES FOR FUND/SERV

The clearing corporation provides the financial services industry with exceptional services at reasonable cost. As participation and transaction volume in Mutual Fund Services expand, greater economies of scale and efficiencies are achieved, allowing us to keep costs and fees as low as possible. The clearing corporation is constantly exploring new ways to provide cost-savings to customers. A Marketing Representative can discuss the fee schedule with you.

PREPARED STATEMENT OF WILLIAM A. BRIDY

PRESIDENT, FINANCIAL DATA SERVICES, INC.
ON BEHALF OF THE
SECURITIES INDUSTRY ASSOCIATION

MARCH 2, 2004

Introduction

Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee, I am William A. Bridy, President of Financial Data Services, Inc., a wholly-owned subsidiary of Merrill Lynch & Co., Inc. My business unit has overall responsibility for the prompt and accurate processing of all mutual fund orders placed through our firm. I am pleased and honored to appear before the Committee on behalf of the Securities Industry Association (SIA)[1] to discuss measures to eliminate late trading, as this Committee has contributed so much to the effort to protect the investing public.

As a preliminary matter, we, and all members of SIA, agree that the practice of late trading is unequivocally illegal, and its very existence threatens to undermine the public's trust and confidence in mutual funds. For this reason, we applaud the strong enforcement actions the SEC and other regulators have taken to date to punish wrongdoers. We believe that these enforcement actions, and the broad attention they have received, have already had a significant deterrent effect on potential wrongdoers and have propelled broker-dealers, other intermediaries, and mutual funds to focus their compliance efforts more sharply on preventing late trading.

We also applaud the expeditious manner in which legislators and regulators proposed rulemaking after evidence of late trading first surfaced in September 2003. In that regard, a manager's amendment relating to late trading was added to H.R. 2420, and the bill, inclusive of the manager's amendment passed the House of Representatives by a vote of 418 to 2 on November 3, 2003.[2] Additionally, 3 of the 4 bills introduced in the Senate contain provisions that address late trading.[3] Furthermore, the SEC has issued its own late trading proposal.[4]

My testimony today will focus on a "hard close" solution at the intermediary level whereby mutual fund orders will be entitled to receive current day pricing, as long as the order is received by a broker-dealer or other intermediary by the time the subject mutual fund determines its net asset value (usually 4 p.m. Eastern), provided certain other conditions are met. The testimony is predicated on two core principles. First, that a critical factor is not where an order is physically located at the time a fund's net asset value (NAV) is determined, but rather whether its receipt by such time can be verified with a high degree of certainty. Second, and most importantly, the available hard close solutions must not be detrimental to, or in any way disadvantage, the tens of millions of honest mutual fund shareholders who are not trying to "game" the system.

Current Proposals

Legislative

Section 205 of the Baker bill contains a provision specifically contemplating a hard close at the broker-dealer, plan administrator or other intermediary level, provided such intermediaries have procedures designed to prevent the acceptance of trades after the time at which NAV is determined, and such trades are also subject to an independent audit to verify adherence to those procedures. Sections 306 and 315 respectively of the Corzine-Dodd and Fitzgerald-Collins-Levin bills contain sub-

[1] The Securities Industry Association, established in 1972 through the merger of the Association of Stock Exchange Firms and the Investment Banker's Association, brings together the shared interests of nearly 600 securities firms to accomplish common goals. SIA member-firms (including investment banks, broker-dealers, and mutual fund companies) are active in all United States and foreign markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs more than 800,000 individuals. Industry personnel manage the accounts of nearly 93 million investors directly and indirectly through corporate, thrift, and pension plans. In 2003, the industry generated an estimated $142 billion in domestic revenue and $283 billion in global revenues. (More information about SIA is available on its home page: *www.sia.com.*)

[2] "Mutual Funds Integrity and Fee Transparency Act of 2003," introduced by Congressman Richard Baker (R–LA).

[3] S. 1971 introduced by Senators Corzine and Dodd, S. 1958 introduced by Senators Kerry and Kennedy and S. 2059 introduced by Senators Fitzgerald, Collins, and Levin. Senator Akaka has also introduced mutual fund legislation (S. 1822), but it does not contain a late trading provision.

[4] SEC Release No. IC–26288 (December 11, 2003).

stantially similar provisions, and neither the Akaka or Kerry-Kennedy bills would preclude an intermediary hard close solution.

Regulatory

In December 2003, the SEC proposed amendments to Rule 22c–1 of the Investment Company Act which would preclude mutual fund orders from receiving current day pricing unless the order was received directly by a fund, its designated transfer agent, or a registered clearing agency by the time the fund establishes its NAV for the day. The SEC's proposal followed a recommendation by the Investment Company Institute (ICI) requiring that all orders be received by the fund company by the hard close in order to receive current day pricing.[5] Although the SEC release accompanying the proposal invited comment on whether the SEC should consider an intermediary approach, contrary to the intent of the legislative proposals, the proposal excludes an intermediary solution. The SEC's proposal also appears to be inconsistent with the spirit of the legislative initiatives, since with respect to a hard close solution at the fund level it provides neither for procedures designed to detect and prevent late trades, nor for required audits to verify adherence to such procedures. This is no small shortcoming given that in testimony before a Senate subcommittee, the SEC has indicated that it found approximately a 10 percent shortfall in late trading compliance *at the fund level*.[6] In a recent press release[7] issued in conjunction with the filing of a comment letter on the SEC's proposal, the ICI moderated its position stating that:

> ". . . The Institute first urged that trade reporting requirements be substantially tightened in early October in the wake of investigations by Government officials that revealed late trading abuses involving a number of mutual funds. In renewing its support for tough new requirements today, Institute General Counsel Craig Tyle also encouraged the Commission to consider whether some intermediaries may already be able to 'document through unalterable means the precise date and time' when orders were received. In such instances, the letter suggests, the SEC should consider the benefits that could accrue to fund shareholders by allowing the intermediary to receive orders on the fund's behalf before the hard 4:00 p.m. deadline."

Feasibility and Implications of Various Hard Close Alternatives

Hard Close at the Fund Level

Essentially, the SEC's proposal allows for hard close solutions only at the fund or registered clearing agency level. In its proposing release, the SEC recognizes that requiring a hard close at the fund level would necessitate that intermediaries establish an earlier (pre-close) cut-off time for investors to submit fund orders and obtain current day pricing, and that with respect to 401(k) plans, investors might not be able to receive same-day pricing at all.[8]

This earlier cutoff would be necessary to allow broker-dealers to perform all essential order reviews prior to the 4 p.m. close. Among other things, that would include analysis to assure that any sales discounts (breakpoints) are properly applied. Even though many things can be done electronically to check for account linkages, much of this is still a manual process. Because of the numerous and varying rules that each fund group follows, many of these orders need to be held in the firm's system and reviewed manually before they are sent to the Fund/SERV system maintained by the National Securities Clearing Corporation (NSCC), and ultimately to the fund. If they are not properly reviewed, investors may not receive the discounts to which they are entitled. Other intermediaries, such as banks, must perform similar tasks prior to sending orders to fund companies.

Orders processed through 401(k) plans[9] involve even more complexities than those faced by broker-dealer recordkeeping systems. For example, 401(k) recordkeepers must place trades collectively, and perform a number of reconciliations at the participant and plan levels when executing transactions. In addition, recordkeepers perform other services that add time to the process, such as determining

[5] ICI Press Release "Mutual Fund Leaders Call for Fundamental Reforms to Address Trading Abuses" (October 30, 2003).
[6] Testimony of Stephen M. Cutler before the Senate Subcommittee on Financial Management, The Budget, and International Security (November 3, 2003).
[7] ICI Press Release "ICI 'Strongly Supports' SEC Proposal to Prevent Late Trading of Mutual Funds" (February 5, 2004).
[8] See SEC proposing release at 4.
[9] Approximately one-third of all mutual fund shares are held in 401(k) plans. See SEC proposing release, note 8.

eligibility for loans, since Federal law regulates the amount of a loan based on a participant's account balance, and there are other complexities that I will leave to my co-panelists to address.

The net results of the earlier cut-off time is that the vast majority of fund shareholders who either prefer, or have no alternative but, to deal through intermediaries (as is the case with 401(k) accounts) would be denied the ability to effect fund purchases at current day prices for at least a portion of, and possibly an entire trading day. Correspondingly, with redemptions, shareholders would be exposed to an additional day of market risk. The SEC proposing release suggests that these earlier cutoff times would not impose a significant burden on most mutual fund investors who are making longer term investments, frequently through 401(k) plan payroll deductions, and who treat the time and date of investment as something of a random event.[10] In essence, the SEC is speaking of those investors who are solely investing periodically in a static manner. This fails to consider a whole range of other activities in which 401(k) plan investors engage, which impose risks that cannot be managed through dollar-cost averaging.

For example, various studies have shown that in 2002 between 14 and 23.1 percent of 401(k) plan participants had outstanding loans, and 21 percent of participants with account balances took a plan distribution.[11] Additionally, a major plan administrator reported that in 1998, 24 percent of their plan participants made exchanges. Furthermore, exchanges increase with age, with a concentration in investors in their 50's and 60's, who have the largest amount of retirement funds. Such participants made an average of 3 exchanges annually.[12] Furthermore, a growing number of 401(k) participants are employing mutual fund portfolio rebalancing services that enable such participants to establish and maintain a targeted asset allocation in accordance with their investment objectives and risk tolerance. Rebalancing usually occurs several times a year. Our firm alone has 800,000 participants enrolled in such a program.

Therefore, the SEC's analysis fails to address what we believe to be the most substantial risks to 401(k) participants—the inability to promptly liquidate or exchange a large mutual fund portfolio in a rapidly declining market. In that regard, it should be noted that during the 5-year period ending December 2003, the Standard & Poor's 500 Index declined by 1 percent or more on 257 days.[13] Thus, a 401(k) participant approaching retirement seeking to liquidate a $500,000 equity mutual fund portfolio,[14] to purchase an annuity in a declining market, could easily lose thousands of dollars by being "locked-in" to his or her investment for an additional trading day. This type of result would potentially cause significantly greater harm to the participant.[15]

In addition to the disproportionate impact on market risk exposure the fund hard close remedy would have on fund investors, it also fails to provide for an effective, tamper-proof, electronic order capture time-stamping system. The proposed remedy merely carries over the same time-stamping requirement already included in Rule 22c–1, which recent history has shown to be prone to abuse both at the fund and broker-dealer levels. We believe adopting the SIA's electronic order capture time-stamping approach for funds, brokers, and 401(k) intermediaries can cure this shortcoming. The problems associated with early order cut-offs cannot be readily resolved, and mutual fund investors should not be faced with the choice of having to either be denied market access during all or a portion of the trading day, or foregoing effecting their transactions through intermediaries—the preferred choice of more than 88 percent of fund investors. Nor should any solution be adopted which creates a competitive disadvantage between financial institutions. Therefore, the fund hard close proposal should not be adopted as an exclusive remedy.

[10] See proposing release, at 5.

[11] See "Beyond the Numbers, The 2003 Annual 401(k) Report," Principal Financial Group, p. 50. Also "Profit-Sharing/401(k) Council's 46th Annual Survey of Profit Sharing and 401(k) Plans," p. 43 (2003).

[12] See "Building Futures: How American Companies Are Helping Their Employees Retire. A Report on Corporate defined Contribution Plans," Fidelity Investments p. 32–33. (1998).

[13] Source: Standard & Poor's Index 1999–2003. Data provided by Reuters.

[14] Assumes $3,000 annual contributions over a 30-year period with an average annual rate of return of 10 percent. The actual annual average return of the S&P 500 for the 30-year period ending December 2003 was 12.2 percent.

[15] The proposing release, note 42, cites a study by Professor Eric Zitzewitz which estimates that fund shareholders collectively lose as much as $400 million annually as the result of late trading. This figure would translate to approximately ½ of a basis point (.00005) of fund assets, based on total fund assets of $7.4 trillion, or about $25 per annum for each $500,000 of fund assets owned.

Hard Close at a Registered Clearing Agency

SIA members and representatives have attended exploratory meetings at NSCC, the only current registered clearing agency, regarding the possibility of developing a systems modification whereby intermediaries could submit mutual fund orders to the NSCC Fund/SERV system at or prior to 4 p.m. NSCC Fund/SERV, through its various linkages, would then transmit the orders to the applicable funds. Therefore, while SIA supports further efforts to determine the feasibility of an NSCC hard close solution, and looks forward to continuing to work cooperatively with the NSCC as the process moves forward, given its current status and the considerable amount of time it will take to develop, it should not serve as an exclusive solution. Under the proposal it would be necessary for intermediaries to transmit "unenriched" orders, which do not include all the data to execute, to NSCC by 4 p.m. in order to obtain current day pricing, and then forward enrichment data (such as information relating to sales breakpoints), after the close. This would essentially turn a one-step process into two steps, and to our understanding it has not yet been determined with certainty what impact that will have on operating efficiencies. Also the NSCC solution is likely to cause intermediaries to batch more fund orders near the close in an effort to reduce the number that will require subsequent transmission of enrichment data. The impact of such batching will need to be addressed. It is, of course, of utmost importance to assure that any systems or procedural changes implemented by NSCC to address late trading do not inadvertently compromise the efficiencies achieved by its mutual fund clearance and settlement process, which has served its participants and investors so well. It is also uncertain whether this would provide sufficient relief to 401(k) plan participants with respect to early cutoff times.

Hard Close at the Intermediary Level

With regard to intermediaries, SIA recommends a three-pronged solution whereby the place of order acceptance to which the hard close would apply, would include:

- *For Broker-Dealers.* The broker-dealer's electronic order capture and routing system which assigns a verifiable order entry time aligned with the atomic clock currently used for equity order time-stamping, provided the other conditions set forth in the Baker, Corzine-Dodd, and Fitzgerald bills are met.
- *For Other Regulated Entities.* The electronic order capture system of regulated entities not currently under the SEC's jurisdiction, but regulated by the OCC or other regulator, which would impose a companion rule to require a hard close on order acceptance by 4 p.m.
- *For Non-Regulated Entities.* Such entities would have to employ an electronic order capture time-stamping system which is functionally equivalent to that utilized by broker-dealers and other regulated entities. Such "functional equivalency" would need to be certified to by an independent third-party and such certification provided to the fund complexes for whom the fund transactions are processed, and the system would be subject to the same independent audit requirements set forth in the pending legislation.

The SIA recommendation contemplates that orders not accepted into the intermediary's system by the hard close, even where the lack of timely receipt was due to legitimate errors, would, without exception, receive next day pricing. Thus, corrections would have to be effected through their error account, and they, not fund shareholders, would bear the economic risk of loss with respect to any orders processed after the hard close. It is most important to note that, unlike the current time-stamping procedure contained in Rule 22c–1, and which would merely be perpetuated in the SEC's proposal, the SIA proposal would impose stringent additional requirements on the use of time-stamping methodology that would make it extremely difficult to "game" the system. The SIA recommendation as it relates to broker-dealers, reflects an approach similar to the NASD's Order Audit Trail System (OATS), which is an integrated audit trail of order, quote, and trade information for Nasdaq securities. The applicable NASD rules [16] required member firms to develop a means for electronically capturing and reporting specific data elements relating to the handling or execution of orders, including recording all times of these events in hours, minutes, and seconds, and to synchronize their business clocks.

Broker-dealers already subject to OATS requirements should be able to readily transfer the OATS technology to mutual fund order processing without incurring significant additional costs. We understand there are a number of service pro-

[16] NASD Rules 6950–6957, approved by the Commission on March 6, 1998, and as amended on July 31, 1998.

viders who may be able to offer similar capabilities to other intermediaries, and that certain other intermediaries may be able to develop this capability internally.

It is our understanding that OATS has significantly enhanced the NASD's ability to track and audits Nasdaq equity orders and detects violations of NASD's rules. Utilizing that same technology for tracking mutual fund orders should bring similar benefits to the SEC's examination staff. Additionally, internal compliance reviews and outside audits of broker-dealers and/or other intermediaries could include some or all of the following:

—written policies and procedures and other controls designed to detect late trading;
—periodic review of such policies, procedures, and controls;
—periodic audits including random testing of orders (conducted both internally and by outside auditors) to validate the integrity of the system; and
—reviews of error accounts to detect patterns that might be indicative of late trading.

In summary, we believe that the SIA recommendation would eliminate the inadequacies of the current time-stamping system and create a readily auditable order trail, while avoiding the significant adverse consequences of an earlier order cutoff time. Furthermore, the SIA recommendation could be implemented expeditiously, whereas the NSCC solution would require a lengthy developmental process, and the funds themselves may not be equipped to handle the large increase in direct transactions that could occur if the SEC's proposal is adopted, without modification.

Conclusion

In summary, SIA believes that electronic and auditable electronic time-stamping systems, which intermediaries and funds would be required to utilize, is a critical component of any effective hard close rulemaking solution. While imposing a hard close at the fund or registered securities clearing agency should be among the available alternatives, these measures should not be the exclusive solutions, given that they either have negative consequences for innocent investors, or remain untested. On the other hand, significant positive experience with electronic stamping system through OATS strongly supports a technological solution. Importantly, this type of approach would place the vast majority of investors holding their fund investments through intermediaries on a more level playing field with other investors.

We commend the Committee for its efforts to swiftly and effectively address abusive practices such as late trading, and believe that such measures are essential to maintaining the integrity of our capital markets, and retaining the public trust of the 95 million Americans for whom mutual funds are a core investment vehicle.

Thank you.

PREPARED STATEMENT OF RAYMOND K. McCULLOCH

EXECUTIVE VICE PRESIDENT, BB&T TRUST

ON BEHALF OF THE

AMERICAN BANKERS ASSOCIATION

MARCH 2, 2004

Mr. Chairman, I am Raymond McCulloch, Executive Vice President for BB&T Trust, based in Raleigh, North Carolina. I have over 26 years of banking experience, the last 12 of which have been focused on BB&T's institutional trust and employee benefit lines of business. I have previously served as Chairman of the American Bankers Association's National Senior Employee Benefit Services Committee and hold the professional designation of Certified Retirement Services Professional. BB&T Trust administers over 2,200 employee benefit plans, with an average of 250 participants and total assets of $5.2 billion. BB&T Trust's parent, BB&T Corporation, Winston-Salem, North Carolina, is the Nation's 13th largest bank with over $90 billion in assets.

I am pleased to testify on behalf of the American Bankers Association (ABA). ABA brings together all elements of the banking community to best represent the interests of this rapidly changing industry. Its membership—which includes community, regional, and money center banks and holding companies, as well as savings institutions, trust companies, and savings banks—makes ABA the largest banking trade association in the country. The views in my testimony today are also endorsed by the ABA Securities Association (ABASA). ABASA is a separately chartered trade association and nonprofit affiliate of the ABA whose mission is to represent before

the Congress, the Federal Government, and the courts the interests of banking organizations engaged in underwriting and dealing in securities, proprietary mutual funds, and derivatives.

The ABA is pleased to testify on the issue of late trading for mutual funds. As investors in mutual funds, either for our own portfolio or for that of our fiduciary and brokerage clients, as well as transfer agents and investment advisers to mutual funds, our members are quite concerned about this issue.

Let me be very clear: *ABA members emphatically believe that late trading has no place in mutual funds.* This practice is illegal under current law and we applaud the enforcement actions of the Securities and Exchange Commission (SEC) and other regulators to punish those at fault. More can be done to prevent late trading. We would submit, however, that any additional legislative or regulatory solutions to combat late trading should: (1) protect mutual fund investors; (2) restore investor confidence in mutual funds; (3) preserve choice of distribution channels; and (4) not limit investment options for mutual fund investors.

The SEC has put forth a proposal, often referred to as a "Hard 4 p.m. Close." This rule, which amends Rule 22c–1 under the Investment Company Act, provides that an order to purchase or redeem fund shares would receive the current day's price only if the fund, its designated transfer agent, or a registered securities clearing agency, for example, the National Securities Clearing Corporation (NSCC), receives the order by the time that the fund establishes for calculating its net asset value (NAV). While at first blush this seems to be a simple solution to the problem, it would in fact result in different cutoff times in practice for mutual fund companies and intermediaries that sell shares of funds of those companies. This would create unnecessary confusion for investors and disruptions in the mutual fund market. *The ABA and ABASA strongly oppose the mandatory Hard 4 p.m. Close as it would have detrimental effects on investors.* Fortunately, technologies exist today that can accomplish the intended goals without risking investor confusion and market disruptions. Thus, in my statement today, I would like to emphasize two key points:

- A "hard close" discriminates against investors based solely upon their choice of distribution channel and denies investors choice by limiting their investment options.
- Alternatives to a hard close exist that can accomplish the goal of preventing late trading without disadvantaging mutual fund shareholders.

I will address each of these in turn.

A "Hard Close" Discriminates Against Investors Based Solely Upon Their Distribution Channel and Limits Investment Options

As mentioned above, the proposed amendment would provide that a mutual fund order receive the current day's price only if received before the deadline for determining the fund's NAV by the fund, its designated transfer agent, or a registered securities clearing agency. Typically, most funds calculate NAV when the major U.S. stock exchanges close at 4 p.m. Eastern Time. *Importantly, fund intermediaries, including broker-dealers and retirement plan administrators, would not be able to receive orders up to that same time. They would be required to establish earlier trading cut-off times—as much as six or more hours earlier—in order to transmit mutual fund orders to the fund, transfer agent or clearinghouse in time for the 4 p.m. hard close.* Thus, it creates *in practice* different cut-off times for mutual fund companies than for intermediaries that sell shares of funds of those companies.

Thus, while the 4 p.m. hard cut-off would eliminate the potential for late trading through intermediaries that sell fund shares, the unintended consequences are severe. We see no reason to fix a problem caused by a few, yet discriminate against the vast majority of mutual fund investors who use intermediaries, including the millions currently saving for retirement through their company's 401(k) or individual retirement accounts. Over $2.11 trillion in assets were invested in defined contribution plans as of year-end 2001, the vast majority of which are in 401(k) plans, according to Employee Benefit Research Institute. As discussed below, there are better, less problematic methods to address late trading.

To understand the problems created by the SEC's proposal, it is important to understand the operational complexities of these transactions. For example, processing 401(k) plan participant orders is an operationally complex and time-consuming task, no matter which type of financial intermediary is servicing the plan. There are multiple processes and systems involved for correlating and transferring data between receipt of the participant's order and delivery of that order to the fund company. Processing trade orders for a typical participant-directed plan involves as many as five steps and four systems between the participant trade request and fund company receipt. Specifically, once the participant communicates a trade request (before

the 4 p.m. Eastern Time market close), it is moved to the primary participant recordkeeping system, where it is given a value and reconciled with that participant's account. The participant's transaction is then combined and netted with others from that same plan, each one having been previously reconciled and valued. Next, the plan's trade orders are combined with other transactions from other plan accounts held by that recordkeeper, which are again valued, netted, and reconciled. The penultimate step requires the recordkeeper's net trade order to be turned over to the intermediary where it is valued and combined with trades of other recordkeepers for a single transmission on each fund. These processing steps are taken after the 4 p.m. close to give plan participants the same consideration for trade orders as a direct investor and to allow both sides (sale and purchase) of an investment option or rebalance of portfolio to occur as of the same trade date.

At BB&T, this process generally takes about 3 hours. Other banks have estimated that this may take 6 hours or more, which means that trade orders would have to be placed *before 10 a.m.* Eastern Time in order to have any chance to get today's NAV. For plan participants located on the West Coast, the chance of receiving that day's NAV is even slimmer.

The discriminatory impact of the proposed 4 p.m. hard close is most clearly illustrated when an individual investor invests in the same mutual fund through three different distribution channels: A retail brokerage account, a 401(k) plan trusteed by a bank, and an account held directly by the mutual fund. Today, if that investor makes an investment decision at 3 p.m. on day one that he or she wants to redeem the mutual fund shares held in all three accounts and communicates that decision simultaneously to all three financial service providers, the investor's trade orders for all three accounts will be effected at today's NAV. *Under the proposed 4 p.m. hard close, the investor's trade order will be effected at two, and possibly three, different NAV prices despite the fact that the decision to redeem was communicated at the exact same time.*

Specifically, the account held at the mutual fund will definitely receive today's NAV. The account held at the brokerage account may or may not receive today's NAV depending on the amount of processing required. The degree of processing required for plan participant orders guarantees that the mutual fund shares held through the 401(k) plan will be priced at the next day's NAV, or possibly the NAV for additional days later. Different NAV prices for simultaneous orders will initially lead to investor confusion and, most likely, create a strong investor bias toward dealing directly with the mutual fund for all types of investment accounts.

The transaction discussed above involves a simple redeem or purchase order. Even more complexity is involved when a participant's order involves a transfer from one fund to another, for example, a simultaneous redemption and purchase. Today, if a participant places an order to sell 1,000 shares of Fund X and uses the proceeds to purchase shares in Fund Y, a bank trustee can process both legs of the transaction, because, some time after the 4 p.m. market close, they have electronically been provided with NAV's for both funds. With a 4 p.m. hard close to the mutual fund, the bank trustee would have to place the order to redeem 1,000 shares of Fund X before 4 p.m. Without a NAV for Fund X, the bank trustee could not place the purchase order for Fund Y before 4 p.m. Instead, the plan participant will purchase Fund Y shares at the next day's NAV. Here, again, a 4 p.m. hard close favors the mutual fund distribution channel over that provided by banks, broker-dealers, and others. Under the proposed 4 p.m. hard close, the participant's redemption and purchase orders will both be effectuated at today's NAV if both Fund X and Fund Y are members of the same fund family.

The differing cutoff times would encourage investors to deal directly with mutual funds or their agents, rather than through intermediaries. Investors who invest directly with the mutual fund will get the benefit of today's NAV, while investors who invest through intermediaries will get the next-day's NAV, at best. The ABA is strongly opposed to a system that discriminates against investors based solely upon their choice of distribution channel.

Creating incentives to deal directly with mutual funds rather than intermediaries would also mean that investors would gravitate to only one family of funds, regardless of whether those funds were "best in class" among all funds of a similar type and investment strategy. Thus, the ability of investors to choose the best combination of funds across all funds that are offered would be limited, denying investors both diversification and potential returns. For example, many employee benefit plans today offer participants fifteen or more investment options from a *variety of mutual fund providers.* For example, at BB&T, we offer over 200 funds from a wide variety of sponsors, including SEI, Managers, Vanguard, Oppenheimer, American, Dodge & Cox, T. Rowe Price, Fidelity, Goldman Sachs, Ariel, Royce, and AIM in addition to BB&T Funds. We trade over 100 funds each day. If a 4 p.m. hard close

is in place, investors may be forced to choose only one mutual fund provider to be able to receive daily valuation and trading. If an investor is invested entirely in one fund family, there is far greater potential for loss if that fund family encounters difficulties. History has shown time and again that lack of diversification hurts investors.

Simply put, a 4 p.m. hard close favors the mutual fund distribution channel over that provided by banks, broker-dealers, and other intermediaries because it allows the mutual fund complex to perform the processing tasks after 4 p.m. while all other providers must perform the requisite processing before 4 p.m. *ABA strongly believes that the SEC should avoid adopting a solution to prevent illegal late trading that discriminates against investors based solely upon their choice of one distribution channel over another.* The consumers should not be sacrificing choice to be able to receive daily valuation.

An Alternative to Hard Close Exists That Will Not Disadvantage Investors

Fortunately, alternatives to the 4 p.m. hard close do exist that would eliminate the potential of illegal late trading without disadvantaging mutual fund shareholders. The key to this solution is to require a tamper-proof order capture system where the entry time of an order can be verified with a high degree of certainty. An independent company would do the time-stamping. *This would allow fund intermediaries to receive orders up to the time of the NAV calculation.*

We believe that the technology exists today to permit the creation of a tamper-proof system for ensuring that trades are, in fact, received at the time the trade is stamped and cannot be altered after the time-stamped without detection. The large volume of daily mutual fund trades requires an electronic network solution. Applications using cryptography, particularly one referred to as public key infrastructure (PKI), are increasingly being used in banks, corporations, and the Federal Government. Digital signatures are one example of how PKI technology identifies the signer and ensures the integrity of the signed data. Digital signatures on every transmission would authenticate the parties involved and also encrypt the content of every message, thereby permitting any alteration to a message content to be detected. Companies are already working to make the "signing" of documents electronically using digital certificates as simple as signing a piece of paper with a pen. Similarly, algorithms are already being used to create a unique identifier or a fingerprint of any file that would work for time-stamping. If the file's contents change at all—even if only an extra space is put in one line—then a different fingerprint is created, making it clear that an alteration has taken place.

Most companies that use digital time-stamping use encryption hardware that is certified by the National Institute of Science and Technology. We believe that the time-stamping of the file should be done by an independent company storing the certified encryption hardware. The company that time-stamps the order would digitally sign the data using digital certificates, thus creating a verifiable and auditable method for assuring the time of the transaction and integrity of the original data. This solution can accommodate trade orders placed by intermediaries either individually or in batch form.

There would, of course, be other associated requirements consistent with this approach that would have to be employed by the intermediary. For example, operating business standards and technical interoperability requirements that ensure consistency and legal reliability will likely be needed. Audit programs and compliance review programs could then examine and validate that the institution's policies and procedures contain the necessary controls to ensure integrity in the trading process.

Thus, the elements of such a system could include:

- Electronic time-stamping of orders in a manner that orders cannot be altered or discarded once entered into the trading system.
- Annual certification that the intermediary has policies and procedures in place designed to prevent late trades, and that no late trades were submitted to the fund or its designated transfer agent during the period.
- Submission of the intermediary to an annual audit of its controls conducted by an independent public accountant who would submit his report to the fund's chief compliance officer.

The ABA recognizes that not all mutual fund companies, transfer agents, or intermediaries have the capability or desire to input a technology solution such as we have suggested. For example, we understand that some mutual fund companies only accept trade orders with original signatures and accompanying medallion stamps through the mail. Moreover, PKI technology can be expensive to implement, although programs that are just now coming to market will make PKI technology

more accessible to smaller financial institutions and intermediaries. Thus, it is important that the approach be flexible, be sensitive to the attendant costs, and provide a considerable implementation period of at least 1 year.

The point is this: Technology exists today—and is rapidly improving—that can be used to create a solution that meets the goal of assuring no late trading is occurring and does not create adverse consequences for investors.

Conclusion

As investors in mutual funds, either for our own portfolio or for that of our fiduciary and brokerage clients, as well as transfer agents and investment advisers to mutual funds, ABA member banks applaud the SEC's goal of protecting mutual fund investors and restoring investor confidence in mutual funds by taking steps to eliminate the potential for illegal late trading. We are encouraged that the SEC is attacking the current market scandals by bringing swift enforcement actions when wrongdoing is uncovered and believe that those who violate the current prohibition on late trading should be brought to justice. We also believe that further regulation designed to prevent or to minimize the possibility of these abuses occurring in the future is warranted.

The ABA appreciates efforts by Senators and Congressmen to assure that solutions to late trading do not disadvantage investors. We are hopeful that with your strong encouragement, the final SEC regulation will recognize this as well; should it not, addressing this through legislation will become necessary.

Thank you for the opportunity to present the views of the American Bankers Association.

PREPARED STATEMENT OF DAVID L. WRAY

PRESIDENT, PROFIT SHARING/401K COUNCIL OF AMERICA

ON BEHALF OF THE

ASPA, ASSOCIATION FOR FINANCIAL PROFESSIONALS, AUTOMATIC DATA PROCESSING, INC., COMMITTEE ON INVESTMENT OF EMPLOYEE BENEFIT ASSETS, THE ERISA INDUSTRY COMMITTEE, FLINT INK CORPORATION, FLORIDA POWER & LIGHT COMPANY, HEWITT ASSOCIATES, ICMA RETIREMENT CORPORATION, INTEL CORPORATION, PROCTER & GAMBLE, PROFIT SHARING/401K COUNCIL OF AMERICA, SMALL BUSINESS COUNCIL OF AMERICA, AND SUNGARD CORBEL

MARCH 2, 2004

Thank you for this opportunity to share the views of the employer-provided retirement plan system with the Committee. My comments reflect the views of the companies and organizations listed on the transcript of my statement. As we all know, mutual funds play a key role in the employer-based system. According to the Investment Company Institute, 36 million U.S. households invest one-third of all mutual fund assets through employer provided retirement plans. Like this Committee, we are concerned by the breaches of trust that have occurred recently and we applaud the efforts underway in Congress to restore confidence in our Nation's financial institutions.

Late trading must be eliminated. At the same time, it is important that we preserve a level playing field for the ability to make investment decisions using same-day pricing. In most employer provided plans, investors can make trading decisions up to, or very close to, a fund's closing time, generally 4 p.m. Eastern Time. Some have questioned if plan participants value same-day pricing. I can assure you that they do as evidenced by the predominance of this feature in 401(k) plans. Like all investors, plan participants adopt a long-term savings strategy and only infrequently make changes in their investment decisions. However, when plan participants do make investment change decisions they highly value same-day pricing. This is particularly true for distribution decisions upon retirement.

Same day pricing in employer provided retirement plans is possible because intermediaries are permitted to process participant trades and forward the final aggregated trades to the funds or a clearing agency after 4 p.m. This late processing is necessary to ensure that all of the requirements surrounding the operation of a qualified retirement plan are met, including satisfying plan features and the highly complex rules issued by the Departments of Labor and Treasury. On a more basic level, fund trade processing is always delayed to reflect the fund's Net Asset Value for the current day—an event that does not occur until well after 4 p.m.

Congress understands the need to preserve same-day pricing in employer provided plans when addressing late trading. The House overwhelmingly passed H.R. 2420 last November. It instructs the SEC to issue rules to address late trading that permit late processing by retirement plan and other intermediaries if procedures exist to prevent late trading and such procedures are subject to independent audit. Similar provisions are found in S. 1971, cosponsored by Senators Corzine, Dodd, and Lieberman; and S. 2059, cosponsored by Senators Fitzgerald, Levin, and Collins. I applaud these Members for their efforts and I urge this Committee to move forward on this important legislative provision if the final SEC rule on late trading fails to preserve equal opportunities for all investors.

Under the SEC's proposed rule, to offer same-day pricing an order must be received by the fund, its designated transfer agent, or a registered securities clearing agency by the fund's closing time. This means that a retirement plan participant's ability to enjoy full same-day pricing will be based on the employer's selection of a plan's intermediary and investment choices. Employers will be pressured to adopt service provider arrangements that favor same-day pricing over an open architecture design with offerings from several fund complexes. Participants could be influenced to invest in the proprietary funds of the intermediary when also offered funds from other fund complexes. Intermediaries will incur significant initial and recurring systems costs that will be borne by participants.

I commend Ann Bergin and the NSSC staff for their valiant efforts to develop a viable process to meet the SEC's clearing agency proposal. Although the clearing agency approach will provide some relief to retirement plan participants that do not trade in a bundled provider arrangement, it will not create parity among investors. It will not accommodate all plan transactions. And it will result in additional costs for many plan participants.

There is a preferable way to address late trading. The SEC has requested comments on an alternative approach that would allow fund intermediaries to submit properly received orders after closing time if verifiable procedures are implemented to prevent late trading. These procedures include tamper proof time-stamping, certification policies, and independent audits. This approach is very similar to that in the legislation I mentioned earlier in my comments. A large majority of SEC commenters, including leading consumer organizations, support inclusion of this approach in the final rule. Several technology companies have confirmed their ability to provide the technological safeguards sought by the SEC.

I hope the SEC's final rule will include this alternative approach that preserves the opportunity for same-day pricing for all retirement plan participants. I repeat my request for this Committee to intercede legislatively if that does not occur.

Thank you for your time. I look forward to answering your questions.

THE REGULATORY LANDSCAPE

WEDNESDAY, MARCH 10, 2004

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10 a.m. in room SD–538 of the Dirksen Senate Office Building, Senator Richard C. Shelby (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN RICHARD C. SHELBY

Chairman SHELBY. The hearing will come to order.

This morning, the Banking Committee continues its examination of the mutual fund industry. As this Committee conducts its hearing process, the regulators have simultaneously worked to reform the fund industry. Both State and Federal regulators continue to bring enforcement actions against wrongdoers, assuring investors that fund executives and brokers who violate their duties will be punished.

These enforcement actions have also helped to define the full scope of transgressions, conflicts, and structural problems that are at the root of the misconduct in the fund industry. In addition to enforcement actions, the regulators have also launched numerous rulemaking initiatives. The SEC is pursuing an aggressive rulemaking agenda aimed at improving the transparency of fund operations, strengthening fund governance, and halting abusive trading practices. The NASD has also proposed rules intended to improve disclosure by broker-dealers to investors at the point-of-sale, alerting investors to potential conflicts of interest affecting an investment decision. Understanding the scope, the application, and the consequences of these rulemakings are a critical component of the Banking Committee's hearing process.

Although enforcement actions and rulemakings are vital elements of the regulatory landscape, we must also consider what regulators can do to prevent future abuses by funds and brokers. I believe that the regulators must demonstrate how they are revising compliance and examination programs to ensure that brokers and funds comply with the current law.

This morning, I would first like to welcome Mr. David Walker, Comptroller General of the General Accounting Office, again to the Banking Committee. Comptroller Walker recently testified before this Committee regarding GSE reform, and we appreciate his willingness to return here so quickly. The GAO has examined the fund industry, and we look forward to its analysis and its insights.

I would also like to welcome Lori Richards, Director of the Office of Compliance Inspections and Examinations at the Securities and Exchange Commission; Paul Roye, Director of the Investment Management Division at the SEC; and Mary Schapiro, Vice Chairman of NASD and President of NASD Regulatory Policy and Oversight, and no stranger to the Banking Committee because, while at the SEC, she used to appear here quite often.

We welcome all of you to the Committee. Your written testimony will be made part of the record in its entirety.

Comptroller Walker, we will start with you. Proceed as you wish.

STATEMENT OF DAVID M. WALKER
COMPTROLLER GENERAL
U.S. GENERAL ACCOUNTING OFFICE

Comptroller WALKER. Thank you, Mr. Chairman. It is a pleasure to be back before the Senate Banking Committee today for the purpose of discussing the GAO's work assessing the transparency of mutual fund fees and other fund practices and to discuss various proposed and anticipated regulatory reforms.

As you know, Mr. Chairman, in the last 20 years mutual funds have grown from under $400 billion to just over $7.5 trillion.

Chairman SHELBY. In how many years?

Comptroller WALKER. The last 20 years.

Chairman SHELBY. Twenty years.

Comptroller WALKER. As you know, mutual funds are not only important from the standpoint of institutional investors, but also for many individuals who invest in mutual funds as part of their retirement security, either through 401(k) plans or savings plans.

I think it is important to note, because of various illegal and abusive practices that have come to light in the last several years, that the SEC is to be commended for placing additional time, attention, and resources in this area. They have taken a number of enforcement actions. They are proposing a number of regulatory actions. And as you know, Mr. Chairman, the NASD is also taking certain actions. I would like to highlight our comments on the SEC's proposals, and I appreciate your putting my entire written statement in the record.

With regard to corporate governance and fund oversight, we believe the SEC is clearly moving in the right direction in order to assure that a supermajority of mutual fund boards are comprised of independent directors and that there be an independent chairman to head these boards. They also are proposing certain other recordkeeping requirements, that there be compliance officers and a code of ethics, et cetera. These are all clearly steps in the right direction.

In addition, we believe that the Congress needs to consider providing the SEC with the legislative authority to better define director independence, because it is one thing to have a supermajority of independent directors, but it is also important to define what "independent" is in terms that will assure in substance as well as form that this requirement is met.

With regard to late trading, the SEC is proposing in the short-term to impose a hard 4 p.m. close on all orders in order to ensure that everybody gets the same price. At the same point in time, we

believe—and I believe the SEC has now acknowledged—that it would be prudent to also explore over a period of time other possible options that might achieve the same result, but without having potential adverse affects on certain investors, namely, employee benefit plan and savings plan investors.

With regard to market timing and distribution practices, we believe that what the SEC is proposing here are also steps in the right direction: Additional disclosure, as well as in the case of market timing, a 2 percent redemption fee on shares that are held less than 5 days that would go into the fund. We think that is clearly a step in the right direction. At the same time, we believe that additional investor education will be necessary with regard to both of these proposed actions.

On 12b–1 fees, the SEC is seeking comments on proposed revisions, which is an appropriate step. We think it is important to also consider as part of that whether or not there should be disclosure of the specific deductions from individual investor accounts with regard to these fees.

On management fees, the SEC is proposing additional fee disclosures in shareholder reports. In our view, we think it is important to figure out how this type of information could be disclosed in the quarterly statements that participants receive. Mr. Chairman, you and I and probably many others have investments in mutual funds, and, quite frankly, the statement that I look at most closely is the quarterly statement. We get all kinds of prospectuses and other types of information, and, frankly, it does not stay in my hand very long. I don't know about yours.

Soft-dollar practices, the SEC is not proposing any specific action at this time, but they are studying the issue. Mr. Chairman, when I was Assistant Secretary of Labor for Pensions and Health, this was an area of concern to us because of pension plan fiduciaries, and we were put in the position of basically having to allow certain types of soft-dollar practices, even though we had concerns from an ERISA fiduciary responsibility perspective because the SEC had already acted in this area.

I think it is very important that the SEC consider narrowing or even repealing the legislative safe harbor and that more disclosure of soft-dollar usage with investor education is potentially called for. This is an area that has been in existence for a long time. In many ways you can call it frequent trading credits, similar to airline frequent flyer miles. And I think that it is something that needs further study.

Thank you, Mr. Chairman. I would be happy to answer any questions after my colleagues have had a chance to testify.

Chairman SHELBY. Ms. Richards, if you will suspend a moment, Senator Schumer has joined us, and he has another hearing that he has to attend, and I want to give him a chance to make an opening statement here this morning.

STATEMENT OF SENATOR CHARLES E. SCHUMER

Senator SCHUMER. Thank you, Mr. Chairman. And I thank you for and appreciate that opportunity. I want to thank every one of our witnesses for being here and I am sorry that I cannot stay. We have a whole bunch of things going on this morning, but I did want

to be here and welcome all of you and just make a couple of brief comments.

The bottom line here, of course, is not just that stock prices are down, but the more we hear of these problems, the average person's trust in the markets goes down. And that is the great worry. The mutual fund industry, of course, has always been a bastion of trust, and so it came as a shock to everybody that so many things were going on. You scratch your head and wonder at some of them, and you say, what has been going on when a multimillionaire breaks the law to make a small extra amount of money? It is a little like Martha Stewart. I care about this industry, as I care about our financial markets, and usually this happens after the fact, but I am sure there are going to be all kinds of things done to deal with all of the illegal and gray-area practices.

I would just like to make one other point here on where I think we have to go—and I use my experience in the credit card industry. Credit card interest rates were at 19.8 percent, and everyone had them at 19.8 percent, and there was not much competition in terms of price until we required good disclosure. And then there was far better competition, and people were far more aware.

And that is the direction I would like to see us all go in, Mr. Chairman. I think we need real simple disclosure. We need to show if you invest $1,000 how much the fund gets, and, of course, it is easier said than done because for some of the funds they will get a set fee and for others it will depend on how well they do. I think we can put in very simple and comparative terms how well each fund has done over the last year, 2 years, 5 years. And that to me will be a prophylactic.

There are some who are proposing far more stringent regimens, but I believe that the free market works, and a really good disclosure system is where we have to go. I am working on that now and hope that I can avail all of you for your comments on it, and you, Mr. Chairman, because that is the direction I think we have to go in. And good disclosure ends up being a real prophylactic for future abuses, as well as creating greater competition. That is the point that I wanted to make here, Mr. Chairman. I do not think there is good enough disclosure now, but I think that is the answer before we try anything that goes further than that—in addition to wiping out all these abuses, some of which are already illegal.

Thank you, Mr. Chairman.

Chairman SHELBY. Thank you, Senator. I think that Comptroller Walker alluded to that a few minutes ago, lack of disclosure when you get a prospectus. I wonder how many people are going to read that or halfway understand it.

Ms. Richards, you may proceed. Thank you for your indulgence.

STATEMENT OF LORI A. RICHARDS DIRECTOR, OFFICE OF COMPLIANCE INSPECTIONS AND EXAMINATIONS U.S. SECURITIES AND EXCHANGE COMMISSION

Ms. RICHARDS. Chairman Shelby and Senator Schumer, thank you for inviting me to testify here today on behalf of the SEC concerning our examinations of mutual funds.

The Commission has undertaken aggressive steps to detect and prevent abusive market timing and late trading. As Chairman Donaldson said when he testified before this Committee in November, mutual fund investors have a right to an investment industry that is committed to the highest ethical standards and that places investors' interests first.

The SEC oversees some 8,000 funds and over 8,000 investment advisers. Because the size of the mutual fund industry precludes a comprehensive audit of every area of a fund's operations, our routine examinations focus on those areas that pose the greatest risk to investors. Examinations identify compliance problems at the individual firms and also help us to identify area of emerging compliance risk. The examiners have identified a number of practices that may harm investors, including, for example, abusive soft-dollar arrangements, favoritism in the allocation of investments, misrepresentations in the sales of mutual fund shares to investors, the inaccurate pricing of mutual fund shares, the failure to obtain best execution, sales practice abuses, and most recently, the failure to give customers the discounts on large-volume purchases of mutual funds.

SEC examiners, along with our enforcement staff, are conducting numerous examinations and investigations to ferret out abusive market timing and late trading arrangements. Prior to September 2003, however, examination staff did not detect the abusive market timing or late trading arrangements that fund executives had with select traders and that came to light as a result of the New York Attorney General's action.

We have been reviewing our examinations to identify lessons learned from those cases and evaluating ways that our examination oversight can be improved, both to detect abusive market timing arrangements and, more broadly, to identify in a timely way other types of misconduct by fund firms.

My testimony today focuses on the changes we are making to our examination oversight, specifically with respect to detecting market timing arrangements and, as I said, more broadly with respect to examination oversight generally. Today, examiners are increasing the frequency and the depth of examination reviews for high-risk firms, increasing the use of technology and data, developing new methods to identify new or emerging areas of compliance risk, conducting more targeted mini-sweep examinations to identify risk areas sooner and more timely, working more closely with other staff at the SEC to highlight the problems that examiners detect, and to identify possible solutions to those problems sooner.

We have identified new examination steps that will help us better detect abusive market timing arrangements. In the past, prior to the discovery of market timing and late trading abuses, examiners reviewed trading by a mutual fund but did not review trading in the fund's own shares. The risk that examiners were concerned about was that funds were trying to inflate their performance returns or take on undisclosed risk that could harm investors.

Our concern was that in attempting to produce strong investment returns that would attract new investors, fund portfolio managers had an incentive to engage in misconduct in the management of the fund. As a result, examiners focused on how the fund was

managed, but because examiners' focus was on the fund itself and not in trading in the fund's shares, examiners did not detect the aberrant trading patterns that could be indicative of abusive market timing.

In addition, although market timing is in itself not illegal, many mutual funds said that they discouraged the practice, and fund firms told us and showed us that they had appointed anti-market timing police who were responsible for detecting market timing trades and preventing market timers from continued trading in their funds. Not detected by examiners was the secret complicity of fund executives in allowing some select market timers to continue to time.

Based on our recent examinations, we have identified ways to better detect market timing. We are obtaining now daily sales and redemption data that can better illustrate to our examiners patterns of trading in the mutual fund shares that could be indicative of market timing, as well as obtaining internal e-mails that may reflect the discussions and arrangements that the firm would not otherwise have shown to our examiners.

Additional new examination steps include a review of personal trading records of fund executives that would show trading in the fund's shares, even in advance of new Commission rules that would require that those records be made available, and a review of procedures to ensure that orders are processed to receive the appropriate day's net asset value.

In addition, we are also implementing other changes to SEC examinations to enhance our ability to detect problems more broadly, as well as to anticipate problems before they become widespread. Once emerging trends and problems are identified, we must share this information with other divisions and offices so that the Commission can bring all of its resources to bear to protect investors.

Let me highlight those changes that I believe are the most important, and they are all described in my written testimony.

First, as Chairman Donaldson announced on March 5th, he has formed an SEC task force that will be drafting the outlines of a new surveillance program for mutual funds. This task force will examine the existing information that is reported by mutual funds, looking at both the frequency of reporting, as well as the type of information that is reported. The goal of such a surveillance program would be to identify indications of problems and then allow examiners to better target their oversight to further reviewing and investigating the problem that has been identified.

Second, examiners have been making increased use of computer technology to review large volumes of data.

Third, examiners have been making increased use of interviews while on site which help examiners better understand the firm and obtain information that may not be available in the firm's books and records.

Fourth, with the additional resources added to the examination program in 2003, we will be examining the largest and highest risk fund firms more frequently.

Fifth, we are conducting more targeted mini-sweep examinations in order to quickly identify emerging compliance problems sooner. We have a number of these mini-sweeps ongoing now.

Sixth, we have added new policies to enhance the speedy resolution of compliance problems that we do detect, including by holding exit interviews with senior fund personnel and by providing copies of our deficiency letters directly to the fund board.

Seventh, we are increasingly requesting written reports from fund firms in order to allow us to review compliance by the fund in between examinations.

Finally, as I said, it is critical that when examiners identify an emerging compliance problem in the industry that we act upon it promptly. To facilitate such actions, examination staff must share exam findings and trends with the Commission and with other Commission staff members.

In sum, Mr. Chairman, we are moving aggressively to implement the lessons that we learned from recent market timing abuses and, more broadly, to enhance our ability to detect other compliance problems in the fund industry.

I would be happy to answer any questions that you may have.

Chairman SHELBY. Thank you.

Mr. Roye.

STATEMENT OF PAUL F. ROYE
DIRECTOR, DIVISION OF INVESTMENT MANAGEMENT
U.S. SECURITIES AND EXCHANGE COMMISSION

Mr. ROYE. Thank you, Chairman Shelby. On behalf of the Securities and Exchange Commission, I am pleased and honored to testify before you today regarding the Commission's recent regulatory actions to protect mutual fund investors. To address the various abuses that have come to light in recent months, and to help prevent abuses in the future, the Commission has embarked on a dramatic overhaul of the regulatory framework in which mutual funds operate. Equally important, the Commission's rulemaking initiatives are aimed at restoring the trust and confidence of investors that are crucial to the continued success of the mutual fund industry and preserving its key role in our economy.

Under Chairman Donaldson's leadership, the Commission is pursuing an aggressive mutual fund regulatory agenda that is focused on four main goals: First, addressing late trading, market timing, and related abuses; second, improving the oversight of funds by enhancing fund governance, ethical standards, and compliance and internal controls; third, addressing or eliminating certain conflicts of interest in the industry that are potentially harmful to fund investors; and, finally, improving disclosure to fund investors, especially fee-related disclosures. I would like to briefly provide you an overview of these actions.

First, late trading. The price that hundreds of thousands of mutual fund investors pay or receive on a daily basis turns on when the order is submitted and to whom. Typically, funds price their shares at 4 p.m. In what is known as "forward pricing," investors submitting orders before 4 p.m. receive that day's price; and investors submitting orders after 4 p.m. get the next day's price. An investor that can place an order to buy or sell fund shares after 4 p.m. and still receive the price set at 4 p.m. can profit from new information in the marketplace at the expense of other fund shareholders.

The current rules permit a large number of intermediaries that accept or transmit trades in fund shares to determine whether the order will receive that day's 4 p.m. price. We know today that this system has failed. In order to help favorite customers, certain intermediaries have "blended" legitimate—pre-4 p.m. orders—with late trades, or post-4 p.m. orders. In some cases, fund managers participated in the scheme; but in many cases they were the victims of dishonesty along with fund shareholders. The problem is that fund companies have no way of identifying a late trade when it is bundled with legitimate trades and submitted to the fund company in the evening hours. There are potentially enormous profits to be gained by late trading, and all of those profits come out of the pockets of mutual fund investors.

To address this abuse, the Commission proposed the so-called hard 4 p.m. rule. This proposal would require that a fund or a certified clearing agency, rather than the intermediaries, receive a purchase or redemption order prior to the time the fund prices its shares for an investor to receive that day's price. Now, we believe that this rule amendment will provide for a secure pricing system that would be highly immune to manipulation by late traders.

We are currently analyzing the comment letters we received on this proposal, and we received over 800 comment letters so far. Now while we believe that the proposed rule amendment would virtually eliminate the potential for late trading through intermediaries that sell fund shares, it is clear from the comments that some believe that the hard 4 p.m. rule should not be the preferred approach. They argue that it will require the intermediaries to have cut-offs for trades well before 4 p.m. and limit investor opportunities to place orders for fund transactions, particularly in the 401(k) context. So, consequently, we are studying other approaches to addressing this issue. We do not want to adversely impact fund investors if there are alternatives that effectively—truly effectively—address late trading abuses.

The Commission has taken a number of steps to address abusive market timing of mutual funds. Short-term trades in mutual fund shares impose costs on funds and their long-term investors. Some market timers attempt to purchase and redeem shares to take advantage of market actions they believe will occur in the future. Other types of market timers attempt to more directly take advantage of the fund's long-term shareholders by exploiting how funds calculate their net asset values. These "arbitrage market timers" buy and sell shares of funds if they believe that the fund's calculation of net asset value significantly lags behind the current value of a fund's portfolio securities, and this is typically in international funds or other funds that invest in thinly traded securities. Over time, the long-term shareholders in a fund will, in effect, pay the costs of the short-term shareholders' transactions and have the value of their fund shares diluted through this activity of arbitrage market timers.

To help prevent this type of activity, the Commission has stressed that "fair value pricing" is a critical tool in effectively reducing or eliminating the profit that many market timers seek. The Investment Company Act requires funds to calculate their net asset values using the market value of portfolio securities when market

quotations are readily available. If the market quotation for a portfolio security is not readily available or is unreliable, the fund must establish a “fair value” for that security, as determined in good faith by the fund’s board of directors. The fair value pricing can minimize market timing and eliminate dilution of shareholders’ interests. The Commission recently reiterated the obligation of funds to fair value their securities to reduce market timing arbitrage opportunities.

Additionally, the Commission has proposed improved disclosure of a fund’s policies and procedures regarding fair value pricing. Our staff is currently gathering information regarding funds’ fair value pricing practices and evaluating whether to recommend additional measures to improve funds’ fair value pricing. We have sought public comment on the need for additional guidance or rulemaking in this area.

In a further effort to reduce the profitability of abusive market timing, the Commission late last month put forth a proposal that would require funds to impose a mandatory 2 percent redemption fee when investors redeem their shares within 5 business days. Again, this fee would be payable to the fund, for the direct benefit of fund shareholders, rather than to the management company or any other service provider.

Now this 2 percent fee is designed to strike a balance between two competing policy goals of the Commission—that is, preserving the redeemability of mutual fund shares and reducing or eliminating the ability of shareholders who frequently trade their shares to profit at the expense of their fellow shareholders. The Commission felt that the rule combined with fair value pricing would make market timing less profitable, and therefore reduce the incentive to engage in market timing. The Commission is considering whether this mandatory redemption fee is an appropriate approach to addressing short-term trading, including abusive market timing.

The proposed rule would also require the intermediaries who sell fund shares to provide the fund at least weekly shareholder identification information that would allow the fund to identify market timers and impose their own market timing restrictions on these investors.

The Commission has proposed enhanced disclosure requirements in order to combat abuses in the areas of market timing and the related issue of selective disclosure of portfolio holdings. These enhancements are intended to deter abusive practices and to enable investors to better understand a fund’s policies in these areas.

The Commission has proposed amendments intended to provide greater transparency of fund practices with respect to the disclosure of a fund’s portfolio holdings. A fund would be required to describe its policies and procedures with respect to the disclosure of its portfolio securities, including any arrangements to make available information about the fund’s portfolio securities, the identity of any person who receives such information, and any compensation or other consideration that would be received by the fund’s adviser in connection with these arrangements. These amendments do not alter the requirement that a mutual fund or investment adviser may disclose its portfolio only if the disclosure of such infor-

mation is consistent with the antifraud provisions of the Federal securities laws and the fiduciary duties owed to fund shareholders.

As you mentioned, Mr. Chairman, recent events in the fund area have highlighted the need to improve oversight of the industry, and the Commission has undertaken several initiatives on this front. They are designed to strengthen the hand of the fund's board and to provide the directors, particularly the independent directors, additional tools with which to protect fund investors and reinforce ethical standards.

In January, the Commission proposed a comprehensive rulemaking package to bolster the effectiveness of independent directors and enhance the role of the fund board as the primary advocate for fund shareholders. The proposals included a requirement for an independent board chairman; 75 percent of the board being independent directors; independent director authority to hire, evaluate, and fire staff; quarterly executive sessions of independent directors outside the presence of management; an annual board self-evaluation; and preservation of documents used by boards in the contract review process.

This significant overhaul of the composition and workings of fund boards is intended to establish, without ambiguity, the dominant role of independent directors on a fund's board. With an independent board chairman and with independent directors representing at least 75 percent of a fund's board, independent directors will set the board agenda, as well as have the power to control the outcome of board votes.

Boards would be required to perform a thorough self-evaluation in order to identify structural changes and processes that might enable the board to be a more potent advocate for shareholder interests. Boards would be required to assess periodically whether they are organized to maximize their effectiveness. As part of this evaluation, boards would consider the number of fund boards on which each individual board member sits, as well as consider the nature and effectiveness of their board committee structures.

The Commission recently proposed that all registered advisers adopt codes of ethics. Advisers are fiduciaries, and owe their clients a series of duties enforceable under the antifraud provisions of the Investment Advisers Act. This bedrock principle, which historically has been a core value of the money management business, appears to have been lost on a number of advisers and their personnel.

The code of ethics would set forth standards of conduct for advisory personnel that reflect the adviser's fiduciary duties, as well as codify requirements to ensure that an adviser's supervised persons comply with the Federal securities laws, and require that these persons acknowledge receipt of a copy of the code of ethics.

The code of ethics is designed to address conflicts that arise from the personal trading of advisers' employees. A principal focus of this code is a requirement that certain advisory personnel report their personal securities holdings and transactions, including transactions in any mutual fund managed by the adviser or an affiliate. This would close a loophole in the Investment Company Act under which investment company personnel have not been required to report trading in the shares of the funds that they manage.

Now in an action that we expect to have a far-reaching positive impact on mutual fund operations and compliance programs, the Commission in December adopted rules that required that funds and their advisers have comprehensive compliance policies and procedure that are reasonably designed to ensure compliance with the Federal securities laws and that they designate a chief compliance officer. In the case of a fund, this chief compliance officer would be answerable to the fund's board and fired only with the board's consent. The fund directors would be required to review the adequacy of these procedures at least annually.

We think an active and independent board of directors, supplied with reliable information as to the effectiveness of compliance programs and procedures, can serve as an important check against abuse and fraud on the part of fund management.

The Commission is undertaking a series of initiatives aimed at certain conflicts of interest involving mutual funds and those who distribute fund shares.

Last month the Commission voted to propose an amendment to Rule 12b–1 to prohibit the use of brokerage commissions to compensate broker-dealers for distribution of a fund's shares. In recent years, it has become clear that the practice of directing a fund's brokerage to a broker or dealer as compensation for distribution of a fund's shares presents opportunities for abuse. Advisers to funds are allocating brokerage commissions to pay for distribution when they could seek lower commission rates or rebates to the fund, or they could reduce custody or transfer agency or other costs of the fund. But the use of directed brokerage to pay for distribution benefits the adviser by increasing advisory fees and lowering the amounts that they would have to spend on distribution out of their own assets.

Now the conflicts of interest that surround the use of brokerage commissions to finance distribution can harm funds and their shareholders and have led the Commission to propose a ban on these types of arrangements.

Over time, Rule 12b–1 has come to be used in ways that exceed its original purpose. Consequently, the Commission in seeking comment on Rule 12b–1, asked for comment as to whether or not the rule should be repealed or modified. To address concerns that Rule 12b–1 has replaced sales loads in many cases, the Commission also requested comment on an alternative approach to Rule 12b–1 that would require distribution-related costs to be directly deducted from shareholder accounts.

Chairman Donaldson has made the issue of soft dollars a priority and has directed the Commission to explore the problem and conflicts inherent in soft-dollar arrangements and the scope of the safe harbor in Section 28(e), and we are working with the Division of Market Regulation to conduct a review of this area. A primary focus is whether or not the current definition of qualifying "research" under the safe harbor is too broad and should be narrowed by rulemaking.

Finally, the Commission is quickly progressing on its continued efforts to improve fund disclosures and highlight for investors fee-related information.

The level of a fund's expenses, over time, can have a significant impact on a fund shareholder's investment experience. So last month, the Commission voted to significantly revise mutual fund shareholder report disclosures to assist investors in understanding these expenses. The shareholder reports will now be required to include dollar-based expense information so that investors can better understand these expenses.

This initiative also includes significantly improved disclosure to investors about a fund's investments. The recent amendments will make more information available and permit investors to tailor the amount of information they receive to meet their particular needs. This additional quarterly disclosure of fund portfolio holdings will enable investors, through more frequent access to portfolio information, to better monitor whether, and how, a fund is complying with its stated investment objectives.

The Commission also proposed revisions to shareholder reports that will require fund directors to explain how they came to renew the advisory contract and make a determination that the fees that they pay the management company are reasonable.

In a major proposal issued in January, the Commission proposed significant revisions to mutual fund confirmation forms and also proposed the first-ever point-of-sale disclosure document for brokers selling mutual fund shares. Together, these two proposals will greatly enhance the information that broker-dealers provide to their customers in connection with mutual fund transactions.

We have seen wide-scale failures to provide appropriate breakpoint discounts on mutual fund sales charges to front-end load funds. We are proposing enhanced disclosure in this area so that investors understand the breakpoint opportunities for these types of funds. We have also issued a concept release to elicit views on how we could require better disclosure of quantification of transaction costs, which can be significant for investors.

Finally, tomorrow, the Commission will consider new proposals to improve disclosure to fund shareholders about their portfolio managers' relationships with the fund. These proposals include disclosure regarding the structure of a portfolio manager's compensation, ownership of shares of the funds that a manager advises, and comprehensive disclosure of specific investment vehicles, including hedge funds and pension funds, that are also managed by the mutual fund's portfolio manager.

As is hopefully evident, the Commission has been extremely busy in crafting rules that are designed to protect our Nation's mutual fund investors. Our focus has been directed not only on addressing the harms of late trading, abusive market timing, and related abuses, but also on strengthening the mutual fund oversight and regulatory framework to minimize the possibility that these and other potential abuses don't arise in the future. Also, we have been focused on the goal of providing meaningful and useful disclosure to facilitate informed decisionmaking on the part of mutual fund investors.

Again, I thank you for the opportunity to be here, and I would be pleased to answer any questions you may have.

Chairman SHELBY. Thank you.

Ms. Schapiro.

STATEMENT OF MARY L. SCHAPIRO, VICE CHAIRMAN PRESIDENT, REGULATORY POLICY AND OVERSIGHT NATIONAL ASSOCIATION OF SECURITIES DEALERS

Ms. SCHAPIRO. Thank you very much, Mr. Chairman. It is an honor to be here and testify before the Committee. I really want to commend you and the Committee for your dedicated oversight in this area. It has been a real catalyst for aggressive and sustained action by the regulators.

The NASD is the world's largest self-regulatory organization. We regulate every broker-dealer in the United States that conducts a securities business with the public. Last year, we brought more than 1,400 enforcement actions and barred or suspended more than 825 individuals from the securities industry, both of which are unfortunately record numbers.

While the NASD does not regulate mutual funds, we do regulate broker-dealers who are a key distribution channel for mutual funds. Thus, we view broker-dealer participation in illegal or unethical practices in this area as a very direct concern.

The disturbing revelations of abuses in the sale of mutual fund shares have brought a redoubling of our enforcement efforts as well as new rules requiring both better disclosure and higher standards for firm conduct. We have also increased our investor education focus dramatically.

The NASD has brought more than 80 enforcement actions against securities firms dealing with mutual funds and variable annuities in 2003 and 2004, and well over 200 cases since the beginning of 2000. We have concentrated our enforcement efforts in four main areas.

First, are compensation arrangements. Last year, NASD and the SEC fined Morgan Stanley $50 million for giving preferential sales treatment to some mutual funds in return for millions of dollars in brokerage commissions and other payments. NASD is currently conducting an examination sweep to look at more than 30 additional broker-dealers and fund distributors for similar violations.

The NASD also prohibits the award of trips, entertainment, or other non-cash incentives to brokers for the sale of the firm's own mutual funds. Last fall, you may recall that we announced a $2 million fine against Morgan Stanley and a censure and a fine against the head of the firm's retail sales division for conducting sales contests featuring trips and Britney Spears and Rolling Stones concert tickets as prizes for the sale of Morgan Stanley's own proprietary funds.

Our second area of focus is the suitability of mutual fund sales, in particular Class B shares. We are very concerned that brokers are making unsuitable recommendations to investors to buy more expensive Class B shares when they frequently are not the best investment choice for the customer. We have recently brought more than a dozen major B share cases involving millions of dollars of unsuitable sales, and we currently have more than 50 open and active investigations in this area.

The third focus is on breakpoints and net asset value waivers. As we reported to you last year, NASD discovered that broker-dealers selling front-end-load mutual funds were not delivering breakpoint discounts to investors, resulting in an overcharge to investors that

is conservatively estimated at $86 million for 2001 and 2002 alone. We have directed all firms to make refunds with interest to investors and, in conjunction with the SEC, jointly sanctioned seven firms. NASD alone sanctioned eight additional firms with fines totaling over $21 million.

In February, NASD brought the first case of its kind in announcing the censure and fine of AXA Advisors and a senior employee for failing to obtain sales charge waivers through NAV transfer programs, thereby causing investors to overpay for certain mutual funds. We have also initiated a broad-based review of other firms to determine if they are meeting their obligations in this area.

The fourth area is late trading and market timing. Last month, NASD announced the first of our market timing enforcement actions. We fined State Street Research Investment Services $1 million for failing to prevent market timing of their mutual funds as a result of inadequate supervisory systems. State Street was also ordered to pay $500,000 in restitution to the funds.

As we continue our examinations and investigations into these areas, we have more than 200 mutual fund-related investigations under way. We will continue to impose fines, order restitution to customers, and suspend or expel bad actors from the industry, charging supervisors and even CEO's. In the appropriate case, we will limit a firm's ability to engage in entire lines of business.

The NASD believes that investors deserve clear and easy to compare information about all the costs associated with the purchase and ownership of every mutual fund, as well as all of the financial incentives that may impact the recommendations of a broker. Therefore, we support the recent SEC proposals on point-of-sale and confirmation disclosure, and we have also proposed disclosure requirements on revenue sharing and differential cash compensation arrangements. By requiring broker-dealers to disclose and update these arrangements, NASD will help investors be alert to financial incentives that a firm may have in recommending a particular fund.

The NASD also filed a new rule yesterday with the SEC requiring that every advertisement that promotes a mutual fund's performance also contains a prominent box with the fund's fees and expenses. This disclosure works a little bit like the Surgeon General's warning: To better inform investors about the cost of purchasing and owning a mutual fund, and it will also enable easy comparison across funds.

From our perspective, success in this realm will require more than rules and enforcement cases. It will require a robust investor education program. NASD recently announced the establishment of a $10 million investor education foundation to further our already significant efforts in this area. Looking ahead, we are expanding our enforcement and rulemaking activities with respect to a product closely related to mutual funds, that is, variable annuity sales. While already active in this area, our focus will be expanded in the following four areas: The market timing in variable annuity subaccounts; switching campaigns by firms and groups of migrating representatives; procedures surrounding sales of variable annuities into tax-deferred accounts; and anti-money-laundering procedures tailored specifically to the annuity business.

In conclusion, NASD will continue to work tirelessly with other Federal and State authorities to solve the problems revealed in recent months in the mutual fund industry. We are committed to building and maintaining the integrity of our financial markets.

Thank you, and I am happy to answer any questions.

Chairman SHELBY. Thank you.

As this Committee examines the fund industry and the recent rulemakings, we are seeking to determine, among other things, if legislation is necessary. In your view, do the regulators currently have the necessary statutory authorities to punish wrongdoers and also to reform the industry? And if not, what additional authorities would you recommend that Congress grant?

We will start with you, Comptroller Walker.

Comptroller WALKER. Chairman Shelby, the two areas that we mentioned in our statement at this point in time is to consider providing SEC with legislative authority to better define director independence and, second, to consider narrowing or repealing the legislative safe harbor dealing with soft dollars. Those are the two issues that we would put on the table at this time.

Chairman SHELBY. Ms. Richards.

Ms. RICHARDS. I would defer to my colleague. I guess I would say that the rules that the Commission has proposed or put in place will help examiners better detect problems.

Chairman SHELBY. It will help a lot, but it is a question of are they comprehensive enough under the statute.

Mr. Roye.

Mr. ROYE. I think from the Commission's perspective, if you look at the various rulemakings that the Commission has pursued and the goals that the Chairman has laid out, we have been able to address each of the problem areas by addressing the specific abuses, trying to enhance the oversight of the industry, and putting in place the building blocks that will hopefully prevent the types of abuses that we have seen from occurring in the future. So, I think our existing authority is generally sufficient to deal with the problems and enhance the oversight of the industry.

I think Mr. Walker does point out specific areas where we do not have the ability on our own to proceed.

Chairman SHELBY. Short of statutory authority.

Mr. ROYE. Yes, sir.

Chairman SHELBY. Ms. Schapiro, you came from the SEC at one time, so you have a great background.

Ms. SCHAPIRO. That is right. I spent 6 years at the SEC, and I think I would agree that there is sufficient authority currently. Certainly for us, our jurisdiction extends only to broker-dealers and not to mutual funds, and we have really quite complete authority in that regard. We will have to rely on the SEC's authority with respect to the issues that need to be resolved that revolve around the mutual funds themselves.

I agree with Mr. Walker that 28(e) is something that Congress should examine carefully with a view toward whether the safe harbor is sufficiently circumscribed—is it too broad and is it allowing conduct to take place that really was never intended by the Congress in creating that statutory safe harbor? There ought to be a careful examination of whether 28(e) should at least be narrowed.

Chairman SHELBY. Okay. Ms. Richards, there are those who say that much of the misconduct that has come to light in recent months was an open secret on Wall Street. Please elaborate on why these practices were apparently undetected by the SEC and how you are modifying examination practices to ensure compliance and better detect future misconduct in the fund industry. Also, do you have the resources you need to address these problems? I think you have to have both the will and the resources. Go ahead.

Ms. RICHARDS. Thank you. Certainly we have the will. I will say to you very clearly that we have since September 2003 spent a good deal of time reviewing our past examinations, our past examination protocols, and identifying what steps we can take going forward to make sure that we better detect not only market timing and late trading but also other abuses of this type.

Certainly we were aware that market timing was a phenomenon in the securities industry. We were also aware that mutual funds were complaining about the existence of market timers and that they were adopting market timing police and other procedures to prevent market timing from occurring in their funds.

As I said at the outset, our examination protocols at the time did not require that examiners receive daily sales and redemptions data which can indicate aberrant trading patterns indicative of market timing. We are now requesting that data as part of routine examinations and, more broadly, as part of the Chairman's initiation of a mutual fund surveillance program, we think that is the type of data that the Commission should receive routinely.

It appears to us in conducting examinations and investigations that, in many of the market timing arrangements, secret and covert market timing arrangements were negotiated via e-mail communications. And in light of that, we believe that all of our examinations must now include a fairly thorough review of e-mails of selected fund executives, and examinations must now include a review of fund executives' trading in the shares of their own funds. And those are steps that we have implemented.

More broadly, I described the changes that we are making to our examinations. We want to make sure that we are tackling and uncovering areas of emerging abuse in a more timely way, making sure that our colleagues on the Commission are aware of problems that we have identified, and that we are taking appropriate steps to bring enforcement actions where appropriate, and to undertake rulemaking, investor education, or other steps.

As to your question about the resources, certainly if we had additional staff, we could conduct additional examinations. We are, however, undertaking a fairly radical change to our examinations. Each examination is likely to take longer than it had in the past because of the review of e-mail and because of the additional examination steps that we are implementing.

The Chairman's initiative to create a mutual fund surveillance program may provide examiners with more efficiencies in the process. That is, if we are able to identify in a more streamlined and systematic way compliance problems in the industry and then use our limited examination staff to target those firms and those areas within firms for follow-up, we may be able to use our existing resources in a more efficient way.

So what I would ask is if I could reserve responding to that question for just a short period of time until we can better assess the effect of the new changes and of the new surveillance program.

Chairman SHELBY. You will get back to us for the record on that?

Ms. RICHARDS. I would like to.

Chairman SHELBY. We want to make sure that you have the resources. You say you have the will, but the will without resources is not good enough. Resources without will is futile, too, is it not?

Ms. RICHARDS. Yes, it is. I would also like to thank this Committee for its support in giving us additional resources in 2003 because that has been enormously helpful.

Chairman SHELBY. Senator Sarbanes.

COMMENTS OF SENATOR PAUL S. SARBANES

Senator SARBANES. Thank you very much, Mr. Chairman. I want to join with you in welcoming the panel.

I actually want to go back to the Chairman's first question to the panel about in what areas is legislation necessary, as opposed to rulemaking and regulation by the SEC. I am not quite clear with what I am hearing.

Mr. Roye, do you agree with Comptroller Walker in the two areas that he mentioned, where he thought legislative action was necessary?

Mr. ROYE. The two areas that he mentioned, first was the definition of independent director in the fund context, the statute sets forth a precise definition. It doesn't give the Commission the ability to expand that definition or to encompass situations where we think that the director really is compromised and shouldn't be deemed to be independent. We have limited ability to deal with that problem. The other area that he mentioned was soft dollars, and, of course, there is a statutory safe harbor that protects soft-dollar arrangements.

The Chairman has created a task force to look at soft dollars. We do have the ability to look at what is research, the scope of that definition. We have the ability to do other things to make the soft-dollar arrangements more transparent and to address other issues. But we don't have the ability on our own to abolish the safe harbor.

Senator SARBANES. Ms. Schapiro, on the 28(e) safe harbor, you said restrict it. What about repealing it? We had testimony here by Marvin Mann before the Committee at the table, the lead independent trustee of the Fidelity Funds, advocating unbundling of portfolio brokerage costs, the elimination of soft dollars through the repeal of Section 28(e), and he said, and I am quoting now from his testimony, "If an adviser wants to purchase research products or other services such as data terminals or other non-execution services or pay a dealer compensation for fund sales to the extent currently permitted by law, it would pay for those in hard dollars from its own resources, not from fund commissions. Investors would have a much better understanding of the expenses of investing in a mutual fund and would be able to make better informed investment decisions."

Ms. SCHAPIRO. Senator, my view is that any practice that is as complicated, as lacking in transparency, and fundamentally conflicted as soft dollars is deserves intense scrutiny by the regulators

and by the Congress. And whether that leads to a narrowing of the 28(e) safe harbor, greater transparency in the disclosure to investors about what portfolio transaction costs are going to execution versus to generate soft-dollar credits, or an abolition of the safe harbor entirely I think is a question for Congress. But I think it is one that is critical to address.

From my perspective, transparency is the absolute minimum. This is an inquiry that could certainly take you to repealing of the safe harbor.

Senator SARBANES. Comptroller Walker.

Comptroller WALKER. Senator Sarbanes, sometimes disclosure is not enough. Disclosure is generally better in addressing competitive issues than it is equity issues. Disclosure can help to promote alternatives, but it by itself does not do enough to prevent abuse. I mentioned before, when I was Assistant Secretary of Labor for Pensions and Health and oversaw all the fiduciary responsibility provisions for the many pension employee benefit plans and trillions of dollars invested relating to those plans, we had serious concerns about soft-dollar arrangements, and we had serious questions about whether they should be allowed under ERISA's fiduciary responsibility provisions.

At the same point in time, we were really constrained with being able to do too much because of Rule 28(e). So, I think that you need to consider the pros and cons of both narrowing and repealing the current safety harbor. I think the time has come to do that.

Senator SARBANES. Does anyone else want to add anything on this issue?

[No response.]

Ms. Richards, at the "SEC Speaks" seminar held just this past Saturday, your staff talked about the top five fund deficiencies in 2003. The staff said that the number one top deficiency was internal controls. We like to keep abreast of these SEC's seminars. Other deficiencies involved filings, board of directors conflicts of interests, and books and records.

Could you just describe a bit about this top deficiency and what is and can be done to improve internal controls? Once again, do you need legislation in order to do it?

Ms. RICHARDS. Certainly. Broadly, the category of internal controls encompasses lack of policies and procedures in a given area, as well as lack of good quality policies and procedures and a failure to implement those policies and procedures. It is a most common finding that we make in our examinations of investment advisers and investment companies, and really incorporates our review of all aspects of a mutual fund or an investment adviser's business—that is, the internal controls weakness could relate to any one of a number of different areas.

I think that what will help improve the quality of mutual funds and advisers' internal controls is the new compliance rule that the Commission adopted in December that will require funds and advisers for the first time to have written compliance policies and procedures in key areas of their operations, and will ensure that there is a compliance officer on staff at the mutual fund to make sure those compliance policies are being administered and enforced. We believe as examiners that the new rule will be extremely bene-

ficial in creating an environment where the internal controls are strong and robust; that is, there are written compliance policies and procedures, and that there is someone inside the fund making sure that those policies and procedures are being enforced.

Senator SARBANES. Thank you, Mr. Chairman.

Chairman SHELBY. Thank you. We will keep going, swap rounds.

This is to Ms. Richards and Mr. Roye. Some contend that the recent scandals continued without apparent detection by the SEC because the SEC's organizational structure did not facilitate information flow across divisions. Would you address that assertion and discuss any internal reforms that the SEC has initiated to enhance internal communication and coordination? Mr. Roye.

Mr. ROYE. The Commission is organized into divisions and offices. My division has responsibility for the rulemaking and the policy in the fund area. Lori's organization has responsibility for going out and doing examinations. We have an Enforcement Division that is out there enforcing the provisions. We try to work together and communicate.

Chairman SHELBY. It is essential that you communicate well, is it not?

Mr. ROYE. It is critical. I guess I would dispute the assertion that the organizational structure is what led to the SEC not picking up on the abuses. What we try to do is learn from our colleagues in doing examinations. When they go out, they spot problems and issues that implicate rulemaking and our policy judgments. We get input from them. When we do rulemaking we use our examination staff as our eyes and ears to understand what is going on in the industry. When we see issues and problems in our review of registration statements of mutual funds, we pick up the phone and call our colleagues in OCIE, or if it is more severe, our colleagues in the Division of Enforcement, to have them go and actually pursue an issue.

But all that being said, the Chairman has set forth a number of initiatives designed to improve internal communication. One is a risk management analysis function. In each of our divisions we have individuals whose function is to think about risk and think about ways that investors can be disadvantaged in each of our respective areas. We serve collectively on a committee that surfaces up these risk management issues. The Chairman is looking for an individual to head up this risk management function. We think that is going to be extremely valuable. We meet periodically to go over the examination findings that OCIE has, not only the Investment Management group, but also the Enforcement group, to look at the types of deficiencies that are being surfaced.

Ranking Member Sarbanes mentioned the five areas where we see deficiencies. From our perspective, does that mean our rules are deficient? Do we need to improve our rules? From an enforcement perspective, are these issues that merit further review and scrutiny on their part from an enforcement perspective? So, we are doing things to enhance our communication, our ability to understand what is going on in the industry.

Chairman SHELBY. Comptroller Walker.

Comptroller WALKER. Mr. Chairman, I would suggest three possible primary reasons why the SEC may not have discovered this

earlier. First, one has to do with resources, staffing levels. Second, it is my understanding the SEC did not dedicate a tremendous amount of time and attention on trading activities dealing with the mutual fund's own shares, and a lot of the abuses have related thereto. Third, some of these practices have involved fraud and collusion, and the degree of difficulty in being able to ascertain that is much greater than the normal type of audit and evaluation type of activities. So, I think those are three of the primary contributing factors.

Chairman SHELBY. Ms. Schapiro, many of the recent revelations regarding the fund industry involve not only wrongdoing by the funds, but also by the brokers. Describe how the NASD has modified your examination practices to account for the large role that broker-dealers play in the distribution of funds.

Ms. SCHAPIRO. I would be happy to do that, and you make a very important point, that broker-dealers were complicit in some of the activity that we have been all dealing with over the last number of months.

We have incorporated new examination protocols, much as the SEC has, into our examination program, and I would be happy to talk about those. We will have to always work closely, as I said before, with the SEC because we can only see a part of the activity that may be problematic. We can only see what has happened in, and is captured on the books and records of, broker-dealers.

I would also agree that when we have a situation where an individual or a firm has either created false documents or destroyed documents, it will always be very difficult for us to detect violations. Nonetheless, we have rolled out to our examination staff across the country new exam protocols for identifying late trading and market timing red flags. Our traditional focus has always been very much in the sales practice area, revolving around suitability primarily. We will not ever take our focus off of those issues as well, because they impact individual investors in a very, very real way every day. Nonetheless, our examiners are now looking for red flags, large trades in and out in a short period of time in a particular account. They review order tickets and other books and records to look for manipulative practices that were intended to circumvent the prohibitions on late trading: For example, they identify whether the firm has access to any system that allows them directly to input an order to the mutual funds after the market close, and they look at all the supervisory procedures, policies and practices that are in place.

With respect to market timing, again, they look at large transfers in and out. They look for whether the broker-dealer might have received a block letter from the mutual fund, and then circumvented that block letter by shutting down one account and opening another account for that customer, who is then unknown again to the mutual fund until the rapid trading begins again. And then we are also reviewing correspondence and e-mails, and working closely with the SEC to share the results of those exams, so we can learn from each other as we develop new techniques for examining for these practices.

Chairman SHELBY. Senator Sarbanes.

Senator SARBANES. Comptroller Walker, your GAO people, in a report, this was testimony over on the House side last June, say "Mutual fund boards follow many sound corporate governance practices, but such practices are not mandatory for all funds." And in the course of the discussion under that heading, they pointed out that you have some reforms advocated by the ICI's best practices and others that have been recommended by blue ribbon groups that are not currently actually required for mutual funds. They were testifying about legislation in order that the legislature would make these and other practices mandatory for all funds, which would ensure consistent implementation of the practices across the industry. Could the SEC do that of its own authority?

Comptroller WALKER. Senator Sarbanes, my understanding is that is exactly what the SEC is proposing to do right now. They are proposing to require that a supermajority of directors of these funds be independent. I think specifically they are proposing 75 percent. They are also proposing that the chairmen of these boards of directors overseeing the funds should be independent. The one thing that we have suggested is you may want to think about providing them with legislative authority to define what is deemed to be independent beyond what the statute says right now. I think they have the authority, but I would ask the SEC to comment.

Mr. ROYE. Yes. If you look at our governance proposal, we do, in connection with a number of exemptive rules that are under the Investment Company Act that involve conflicts of interests, we expect boards of directors to manage and oversee those conflicts. We are proposing to attach to those rules about five different governance principles. And as Mr. Walker mentioned, requiring a 75 percent independent board, and an independent chairman, confirming the authority of the directors to retain staff, particularly the independent directors, to go out and hire experts to assist them in carrying out their responsibilities, requiring them to meet in executive session as a group of independent directors to confer on issues, as well as requiring the directors to go through a self-evaluation as to whether or not they are effective, and what they can do to improve that effectiveness.

Senator SARBANES. Has the SEC gone through the exercise of ascertaining what additional statutory authority they think they need or what current provision in the statutes ought to be changed with respect to the mutual funds? Have we had the benefit of your recommendations in that regard?

Mr. ROYE. We have not done that, per se. The Commission has taken a position, for example, on earlier versions of the Baker bill on the House side, where there were various provisions that were in that legislation, and testified in support of a number of those provisions, and then——

Senator SARBANES. Were you testifying in support of provisions that you are now seeking to put in place by rule or regulation?

Mr. ROYE. Much of what was in the Baker bill you see the Commission, through its rule proposals, actually proceeding on.

Senator SARBANES. I am beyond that. One of the questions we have to face is if you are doing it by rule and regulation and it can be accomplished, should we just leave it there or should we come along and also by statute require that. Of course, if you require it

by statute and then subsequently you need to adjust it, you have to adjust it by statute. So, you have to be mindful of that.

But I want to go beyond that. I want to get at difficulties or problems you see in which you think your authority under the statutes is not sufficient or adequate, and therefore, you would come to us and say: We can do A, B, C, D, and E, but we do not think we can do F, G, H, and I unless we get some change in the law. Have you done that exercise?

Mr. ROYE. I can tell you this: As we work with Chairman Donaldson on his action plan, everything that he has wanted to do we figured out a way to do it with our existing authority.

Senator SARBANES. But you just admitted at the table today, as I understood you, that in at least the two instances that Comptroller General Walker indicated, where he thought legislative action was necessary, you agree with that.

Mr. ROYE. That is correct, and the Commission is on record on the House side as supporting additional authority to be able to deal with the independent director definition. And as I indicated, Chairman Donaldson has formed a task force to look at the soft-dollar issue, and the Commission, as yet, has not formulated a position on that, but if you want to go so far as to repeal that, we do not have the authority to do it on our own.

Senator SARBANES. Is that task force at work?

Mr. ROYE. Yes.

Senator SARBANES. When does it intend to report?

Mr. ROYE. We have only about 15 things we have been trying to do all at the same time, but Chairman Donaldson has definitely made this a priority, and I cannot give you a firm time frame, but if you look at the speed with which we are moving in all these other areas, he is going to demand a report from us probably in short order, but I cannot give you a specific time frame.

Senator SARBANES. Did you want to add something, Comptroller Walker?

Comptroller WALKER. Senator Sarbanes, I would just say one of the things that I hope that the SEC is looking at, as well as part of its review is whether it believes it has adequate sanctions, whether it has an ability to impose high enough and targeted enough civil penalties, and whether or not in certain circumstances criminal sanctions might be appropriate for certain extreme abusive practices.

I do not know what if anything they are doing on that, but I do know that in order for any system to work, you have to have incentives for people to do the right thing, adequate transparency to provide reasonable assurance they will because somebody is looking, and appropriate sanctions via accountability mechanisms if they do the wrong thing, if you do not have all three of those, the system will not work over time, and it does not make any difference whether it is a corporate governance system or the mutual fund industry or the health care system or the tax system, you have to have all those.

Senator SARBANES. Thank you.

Chairman SHELBY. As I understand it, the SEC is talking about 75 percent of the directors be independent, right?

Mr. ROYE. Yes, sir.

Chairman SHELBY. Why should the chairman be independent? Why should that not be left up to the directors to elect a chairman that would be deemed by them the leader and the most competent and so forth, as opposed to just mandating that the chairman be independent? This was brought out last week up here.

Let me start with Ms. Schapiro.

Ms. SCHAPIRO. We have not taken an institutional view on this, as you can understand, because we do not regulate the funds themselves. I will say I think there is a tremendous amount of learning that has gone on over the last couple of years, given the corporate scandals that we have all witnessed, and I think that lead directors or independent chairmen and a number of the other things the SEC has already proposed, are very important for the fund industry to catch up in terms of the quality of governance that is taking place there, but I am going to defer to the SEC on the issue of whether this should be an independent chairman or a lead director.

I do think a supermajority of independent directors is critically important.

Senator SARBANES. Seventy-five percent?

Chairman SHELBY. Of the directors?

Ms. SCHAPIRO. Yes.

Chairman SHELBY. Comptroller Walker, do you have a comment?

Comptroller WALKER. Mr. Chairman, I think it is important to have an independent chairman. Now whether that is a lead director or whatever, because to me boards have to do three things. They have to maximize value to shareholders. They have to manage risk to stakeholders and they have to hold management accountable for results. The lead director or the chairperson sets the agenda and has a tremendous amount of influence over the board's activities, and I think it is an important issue.

Chairman SHELBY. Comptroller Walker, would you elaborate on the GAO's assertion that investors should receive individualized cost disclosure? Has the GAO evaluated the cost and feasibility of computing such a figure?

Comptroller WALKER. I think it is important that we keep in mind that it is not just what is disclosed but how it is disclosed and where it is disclosed. Our experience has been, and frankly, my personal experience has been——

Chairman SHELBY. How it is disclosed to where the shareholder can understand it.

Comptroller WALKER. Correct. I know myself, having investments in a number of mutual fund shares, most of which, frankly, are through a 401(k) plan, the thing I look at on a recurring basis is my quarterly statement. There are annual reports that come out. There are prospectuses that come out, and they have a lot of information, but at least from a personal standpoint, I do not spend a whole lot of time on them.

I think we need to figure out how we can get important information provided in a simple, straightforward manner in a statement that we believe that people will read.

Chairman SHELBY. People will understand.

Comptroller WALKER. And understand.

Chairman SHELBY. And understand too.

Mr. Roye.

Mr. ROYE. I would agree with what Mr. Walker has indicated. The Commission has taken a number of steps to try to improve and simplify mutual fund disclosures. We made a major effort to try to improve the prospectus presentation. You alluded to the fact that the prospectus is something that many investors do not spend a lot of time focusing on. We want that document to be something that investors do focus on and can understand. Up front in that document is a fee table that lays out the fees and expenses. We recently went through an effort to improve the shareholder report presentation, and it does have the new dollars and cents disclosure Senator Schumer referred to in terms of $1,000, what does it cost me per $1,000 to be invested in the fund? Also formulations that allow you to compare one fund to another. Is my fund a high-cost fund or a low-cost fund?

I will add that, as we worked through these disclosures recently with the Commission, a number of the Commissioners, and the Chairman have directed the staff to think about how we can go further in looking at issues like account statement fee information.

Chairman SHELBY. For example, why could investors not receive both an individualized number and a comparative number?

Mr. ROYE. That is certainly possible. I think that when you get to the account statement, one of the things that we have to work through is that there are a number of complications in doing that. Most fund shares today are sold through financial intermediaries, broker-dealers, banks, other intermediaries, and they are the ones who generate the account statement. So the funds are going to have to get the expense information, transmit it to a variety of—thousands of—intermediaries. Let us say you have 10 different funds that you are holding through that intermediary, they are going to have to bring all that information down to an account statement and get it out 5 days after the end of the quarter, which creates some processing issues that we would have to work through, but it is something that we are focusing on.

Chairman SHELBY. Mr. Roye, could you please just briefly elaborate on how the SEC intends to address the potential conflicts of interest inherent in the side-by-side management of hedge funds and mutual funds? Maybe Ms. Richards would have something to say there to.

Mr. ROYE. I think in the first instance we have the compliance policies and procedures requirement that the Commission recently adopted. Funds are going to have to have procedures and policies in place to deal with exactly these kinds of issues. If you look at the release you will see a discussion of just this kind of issue, side-by-side management, of a mutual fund, hedge fund, other accounts. How do you manage those conflicts? What are your procedures? The rules also require a compliance officer in every fund, and every adviser who is responsible for overseeing those procedures, to report to the board of directors as to whether or not those procedures are working.

Tomorrow, we are recommending to the Commission enhanced disclosure about fund portfolio managers. How is your portfolio manager compensated? How is that compensation structured? Does the portfolio manager own shares of the fund? Maybe more significantly, what other accounts is your mutual fund manager running

at the same time that he or she is running a mutual fund? Is the manager running a hedge fund, as well as a registered mutual fund? Again, disclosing to investors what the fund's policies and procedures are and how you manage that conflict?

Chairman SHELBY. Ms. Richards, do you have any comment?

Ms. RICHARDS. This is an area, I think, with significant conflicts of interest. Whenever a portfolio manager manages more than one account and may be paid in different ways for the success or failure of any one of those accounts, the manager may have an incentive to mismanage one account or to favor one account over another. As a result, this is an area where we try to look closely at the allocation decision the portfolio manager makes during examinations. It is also an area where the Commission has found abuse—where a portfolio manager has allocated a hot IPO, for example, to an account where he will receive more money for the favorable outcome.

Just in the last year or so, the Commission brought a case against Zion Management, and a case against Nevis Capital, and in prior years against Dreyfus and Van Kampen, so it is clearly an area where there is conflict of interest and the potential for abuse.

Chairman SHELBY. Senator Dodd.

COMMENTS OF SENATOR CHRISTOPHER J. DODD

Senator DODD. Thank you, Mr. Chairman. My apologies to you and Senator Sarbanes and the witnesses. We had a hearing in the Rules Committee of 527's. I know there is a great deal of interest in that subject matter, so I apologize for not being over to hear some of the earlier statements and the comments of my colleagues. If I am raising a question here, Mr. Chairman, that has already been covered, then interrupt me and we will wrap this up. I just want to raise one question.

In a bill that Senator Corzine and I put together some months ago, we did not include a hard 4 o'clock close. I know this is not the first time you have been asked about this question, but the obvious concerns that have been raised about a hard 4 o'clock close are the two classes of investors, East Coast investors and West Coast investors, and making it difficult for them to get in and out of trades in the same day if you have a 1 p.m. cut-off. That is the argument that is being raised.

I gather in—I should know which one—the opening statements, there was some reference to the SEC's examination of alternatives to the hard 4 o'clock close, and I wonder if you might comment on some of those alternatives and explain the benefits and problems of the clearinghouse for orders and electronic time-stamping of orders to ensure their veracity. Any of you want to jump at this?

Mr. ROYE. I would be glad to respond to that since it was our rule proposal. We did propose a hard 4 o'clock, and as I indicated in my statement, we are looking at a situation of widespread abuse in this area, abuse by intermediaries that the Commission regulates and the NASD oversees, but in some cases intermediaries that are not within the jurisdiction of the Commission. These include banks and third-party pension plan recordkeepers who are accepting orders, and who are blending late trades with legitimate trades so the funds cannot see those orders. So, we are faced with the questions of how do we attack that problem?

If you think about the thousands of intermediaries taking orders, the solution the Commission proposed was to shrink that universe down to entities that we regulate and oversee. We regulate the funds, we regulate the clearing agencies that take the fund orders, but you are right, in doing that, you require the intermediaries to have earlier cut-offs in terms of accepting orders. But we are trying to deal with a situation where there are folks that we do not regulate, and to come up with a solution that we thought would solve the problems. We recognized in the release that the rule proposal was going to have the kinds of potential impacts that you mentioned in terms of 401(k) issues, with West Coast investors having to get their orders in.

At the same time the Commission recognized and asked for comment on an alternative to a hard 4 o'clock. Is there a way, through procedures, time-stamping, electronic time-stamping, where orders cannot be altered through certification processes or third-party audits? Is there a solution that would give us reasonable confidence that we are not going to have a late-trading problem in the future?

We received about 800 comments on this particular rulemaking.

Senator DODD. Is that particularly high?

Mr. ROYE. That is very high for an SEC rule proposal. I think the only one that I can recall that exceeded that was the Commission's proxy voting proposals, requiring mutual funds to disclose how their proxies are voted.

Senator SARBANES. That was in the thousands, was it not?

Mr. ROYE. Oh, yes.

[Laughter.]

Consequently, when we started looking at this problem, we did not want to do anything that adversely impacts the ability of investors to get their orders in. We wanted them to have the widest window of opportunity to get the orders in. At the same time we do not want to be up here 2 years from now talking about late trading problems. Therefore, we are trying to understand alternatives, understand technological solutions to this. We have been working with Fund/SERV, the clearing agency. We want to hear from everybody in terms of solutions and alternatives. I can tell you that some of the alternatives we have seen and some of the intermediaries that have some of those procedures in place already, we found late trading.

We are looking at it very carefully. We are going to be very careful in this area, and explore all the alternatives.

Senator DODD. Comptroller Walker or anybody else want to comment on this?

Comptroller WALKER. Senator Dodd, we at GAO have recommended that the 4 o'clock hard close might be the option that the SEC does right now, but they need to be looking for possible alternatives. The fact of the matter is, is that there is going to be a difference between people who live on the East Coast and the West Coast, no matter what the time is. That just exists. I think one of the issues that we have to think about is, is that what are we trying to accomplish?

Part of this is there are differences here between short-term traders and long-term investors, and in the case of pension funds and 401(k) plans, I hope that we are promoting people to be long-

term investors, not short-term traders. I think if we look at the date with regard to pension and savings plans like 401(k) plans, you will find that a vast majority of participants do not trade on a frequent basis, and they are making asset allocation decisions and sticking with it over a longer term, and so this issue may or may not be as big a problem as some would lead you and others to believe.

Senator DODD. Anybody else?

Ms. SCHAPIRO. Senator Dodd, I would add I think you have highlighted important issues with respect to a dramatically shortened trading day for West Coast investors and difficulties for pension plan administrators who have a need to net positions before they transmit them to the fund, and I think the SEC has done the very logical thing to do in the first instance. But there are systems I think that can give you an unalterable electronic audit trail that are worth looking at.

We administer an equity order audit trail for Nasdaq securities that captures 100 million reportable events electronically every day in the life of an order, so that there is an electronic time-stamp when an order is received at a branch office—this is for an equity security—when it is transmitted to a trading desk, if it is modified or canceled or altered in any way, and that data is then batch transmitted overnight to NASD for analysis through our surveillance system. That is a kind of system with tremendous capacity that may be a prototype or an analogy to look at for the mutual fund industry so that we can get the balance right. We do not want to disadvantage investors, particularly retail investors, by shortening the trading day, but we most certainly want to close the loop that permitted late trading to go on.

Senator DODD. Ms. Richards, you want to comment?

Ms. RICHARDS. I would just say that the current system is extremely vulnerable to late trading because of the way that orders are processed after 4 p.m. and batched, and also because of the fact there are so many intermediaries that process fund shares that are not regulated by securities regulators. So any alternative solution that would encapsulate these other nonregulated intermediaries would have to somehow incorporate an oversight mechanism, as well as some requirement that would bring them into the fold.

Senator DODD. But you would agree that there are some inherent disadvantages in a hard close rule at 4 p.m.?

Ms. RICHARDS. Yes, but as an examiner I am looking for the permanent fix to the problem. So, I come at this from a little bit different point of view.

Senator DODD. How do you feel about the PATRIOT Act? I will not ask that.

[Laughter.]

Thank you very much, Mr. Chairman.

Chairman SHELBY. Ms. Schapiro, it is important, I believe, that investors receive full disclosure concerning any incentives that may influence a settling broker. Would you discuss and compare your respective rules regarding point-of-sale disclosure?

Ms. SCHAPIRO. I agree with you completely, Mr. Chairman. The ability for a broker-dealer in terms of the funds it includes on its preferred list, and the ability of a broker to recommend a particular

fund to a particular investor can be influenced by payments that are made either to the brokerage firm or to the registered rep, and investors absolutely should know what those incentives are that may have skewed the recommendation they are receiving.

We have proposed two rules, one with respect to revenue sharing and buying that shelf space at the broker-dealer by the fund——

Chairman SHELBY. Would this be in confirmation statements?

Ms. SCHAPIRO. This will be at account opening time, then updated and posted continuously on the website of the broker-dealer, so that when you opened your account, you would be told, "We offer the following 30 mutual funds. These are the ones that pay us for shelf space so that we will offer them to you and give them a preferred spot in our supermarket." You would be able to see all of that information on the website, and also be told it at account opening time.

The other piece would be that an investor would get, again, account opening or point-of-sale disclosure with respect to the fact that the registered rep of that broker-dealer may get a higher payout from his firm for offering or recommending to you and having you purchase a particular mutual fund. I think this information is absolutely critical to an investor making an informed decision and understanding that brokers can sometimes be motivated by more than just what is in the best interest of the investor.

Chairman SHELBY. Mr. Roye, could you discuss the role of the 12b–1 fees and how these fees have evolved since their inception? Do they still serve their intended purpose?

Mr. ROYE. 12b–1 is a rule that the Commission adopted in 1980. It is a rule that allows funds to use fund assets to facilitate the distribution of fund shares. It was put in place in 1980 in a time when the fund industry was in net redemptions, and funds were shrinking, and it was a method believed at that time to be sort of a temporary measure to bring in assets to the fund, and maybe lower overall expenses. Investors would benefit from the use of assets to bring in additional monies which would then bring down fees and expenses.

It has evolved over time that 12b–1 fees are effectively an alternative to a sales load. As you have seen, mutual fund sales loads dropped over the years since 1980. I think the maximum was 8½ percent. Now the average fund and sales load is somewhere around 4½, 5½ percent. So, you have seen the sales loads drop. But then you see 12b–1 fees being introduced and used as a substitute for sales loads. Indeed, the NASD's maximum sales load rule now treats these asset-based fees as the equivalent of a sales load. You have funds that can charge 12b–1 fees up to 100 basis points in their expenses to pay for distribution-related expenses.

The Commission, as I indicated, has proposed to amend 12b–1 to prohibit directed brokerage arrangements, whereby commissions, which we view as fund assets, are being used to facilitate distribution, perhaps being used to circumvent the NASD's maximum sales load rule. The Commission has asked for comment as to whether or not we should move further and modify that rule. Should the rule continue to exist, be repealed? The Commission also asked for comment on a different approach to paying for distribution expenses. Should the investor who is generating the distribution

costs, a new investor coming in, rather than paying the sales load up front, pay that distribution expense over time, as opposed to coming out of fund assets. There you have the investor actually paying their own freight, if you will.

Chairman SHELBY. Comptroller Walker.

Comptroller WALKER. A lot has changed since 12b–1 was put into place, and I do think it is appropriate that the SEC review and reconsider whether and to what extent these arrangements should continue to be allowed, and to the extent that they decided that they should be, then additional disclosures might be necessary to allow investors to understand exactly how much we are dealing with here.

Chairman SHELBY. Ms. Richards, to the extent that you are permitted, could you discuss any new examination sweeps or targeted inspections that OCIE is conducting? For example, recent press accounts report that you are investigating potential wrongdoing among pension consultants and are examining index funds that have high expense ratios are paying soft dollars.

Ms. RICHARDS. Yes, sir, both of those press statements are accurate. We are increasing the number of mini examination sweeps that we conduct, targeted to particular areas where we believe there is a risk of violations or problems. In our review of investment consultants, the concern is that these consultants are providing advice to pension plans and other investors about which money managers to retain. These consultants may also provide other services and have other products that they provide to money managers. We are interested in the intersection between those two things, that is, whether the consultant in any way influenced in recommending particular money managers to a pension plan by the receipt of monies that it is receiving from money managers. We are interested in the conflicts of interest that may exist in this area, and the extent to which these consultants are disclosing the conflicts of interest to their customers, the pension plans. So, we initiated a fact-finding review of this area in December.

The other area that we are very interested in is the use of soft-dollar commissions by index funds. Are index funds using their customers' brokerage commissions, an asset that belongs to the fund, to purchase research? We question why an index fund would need to acquire research inasmuch as it is invested in the index. We are again conducting a fact-finding review.

Other areas that we are exploring are payments by mutual funds for shelf space, as Ms. Schapiro mentioned, valuation and pricing of bond funds in light of the enforcement action the Commission brought against Heartland Investment Advisors for mispricing two of its bond funds; fair value pricing by foreign funds; U.S. funds that are invested in foreign securities appropriately fair valuing the stocks in their portfolios; and the use of affiliated service providers by a mutual fund that may retain an affiliate to provide key services and how are those negotiations for services negotiated, for example. Are they negotiated at arm's length? What price does the fund pay for affiliated service? Performance claims by investment advisers is an area where there has been significant abuse in the past with investment advisers misrepresenting or overstating their performance. We are also looking at small fund complexes that

may not have enough assets or enough financial ability to adequately manage their compliance programs, as well as a number of other areas.

Those are examples of areas where conducting targeted mini-sweeps are likely to indicate problems, and lead to solutions in a rapid fashion.

Chairman SHELBY. Ms. Schapiro, would you comment, if you can, on any pending or anticipating examination sweeps by NASD concerning the fund industry?

Ms. SCHAPIRO. Sure. We are still engaged in sweeps with respect to late trading and market timing, about 58 different firms under scrutiny in that area.

Chairman SHELBY. Fifty-eight?

Ms. SCHAPIRO. Yes, 58 firms. We are doing an intense review of the B-share sales, where we are looking at eight very large broker-dealers to understand the extent to which they engaged in large transactions, either single transactions or transactions accumulated over a period of time, in B shares that would have been far cheaper for the individual investor, had they been done in A shares. As I said in my opening statement, we continue to have a great concern that the most expensive products are not necessarily the best products being offered to investors.

We have 10 firms that we are currently looking at for these net asset value transfers, where investors should not have been charged a new front-end load, but were, and so were overcharged.

Chairman SHELBY. Does this involve a lot of money?

Ms. SCHAPIRO. Yes. It involves a significant amount of money. And we are looking at directed brokerage in about 50 instances, and sales contests, much like the Morgan Stanley case, although perhaps not quite as flamboyant.

Chairman SHELBY. In directed brokerage, you are talking about a lot of money here too, are you not?

Ms. SCHAPIRO. Yes. And bad disclosure.

Chairman SHELBY. Billions of dollars maybe?

Ms. SCHAPIRO. We are looking at very, very large payments, yes.

Chairman SHELBY. Unusual payments?

Ms. SCHAPIRO. Large payments, yes. Then finally, with respect to breakpoints, an area where we have had really intimate involvement, 625 firms that failed to give breakpoint discounts to their investors will have to be reexamined since we have ordered them to give those discounts with interest to investors, and over the next period of time, and maybe it is a year, we will have to go back into each of those 625 firms and determine that they did, in fact, fulfill their obligations to refund that money to investors.

Chairman SHELBY. Comptroller Walker.

Comptroller WALKER. Mr. Chairman, the only thing I would say is I would hope that both the SEC and the NASD are coordinating their related activities with the Employee Benefit Security Administration at the Labor Department, who has responsibility for enforcing the fiduciary responsibility provision and has a significant amount of sanctions available to them, both civil and criminal in dealing with illegal and abusive practices.

Chairman SHELBY. Ms. Richards, do you want to comment on that? If not, why not?

Ms. RICHARDS. Yes, sir, we will do so. We will communicate with the Department of Labor.

Ms. SCHAPIRO. Absolutely.

Chairman SHELBY. I thank the panel for your informative statements today, and we will continue our examination of the mutual fund industry with more hearings to come. Thank you very much. The hearing is adjourned.

[Whereupon, at 11:40 a.m., the hearing was adjourned.]

[Prepared statements and response to written questions follow:]

United States General Accounting Office

GAO

Testimony

Before the Committee on Banking, Housing and Urban Affairs, U.S. Senate

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MUTUAL FUNDS

Assessment of Regulatory Reforms to Improve the Management and Sale of Mutual Funds

Statement of David M. Walker
Comptroller General of the United States

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Highlights

Highlights of GAO-04-533T, a report to Chairman, Senate Committee on Banking, Housing and Urban Affairs

Why GAO Did This Study

Since September 2003, widespread allegations of abusive practices involving mutual funds have come to light. An abuse called late trading allowed some investors, at times in collusion with pension plan intermediary, broker-dealer, or fund adviser staff, to profit at other investors' expense by submitting orders for fund shares to receive that day's price after the legal cutoff. Other investors were allowed to conduct market timing trades to take advantage of stale prices used by funds to calculate their net asset values at funds with stated policies against such trading. SEC and other regulators have responded with numerous proposals for new or revised practices. Based on a body of work that GAO has conducted involving mutual funds, GAO analyzed and provides views on proposed and final rules involving (1) fund pricing and compliance practices intended to address various mutual fund trading abuses that have come to light recently, (2) fund boards' independence and effectiveness, (3) fund adviser compensation of broker-dealers that sell fund shares, and (4) additional actions regulators could take to further improve transparency and investor understanding of the fees they pay.

What GAO Recommends

In this statement, GAO raises a number of issues for regulators to consider that could enhance the effectiveness of proposed rule changes.

www.gao.gov/cgi-bin/getrpt?GAO-04-533T.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Richard J. Hillman (202) 512-8678 or hillmanr@gao.gov.

March 10, 2004

MUTUAL FUNDS

Assessment of Regulatory Reforms to Improve the Management and Sale of Mutual Funds

What GAO Found

GAO commends SEC and other regulators for their swift regulatory response to recently revealed abusive mutual fund practices. However, some proposed actions need to be thoroughly assessed to ensure equitable treatment for all investors and others will need to be reinforced with enhanced compliance, enforcement, and investor education programs to be truly effective. In particular, to prevent further late trading, SEC has proposed that all mutual fund orders be received by funds or designated processors by 4:00 p.m. Eastern Time, but this action may unfairly impact some retail investors that place orders through financial intermediaries. Although GAO supports in the short run the proposed hard 4:00 p.m. close as a way of increasing the certainty that all orders have been legitimately received, GAO believes that SEC should continue to work with industry participants, including pension plan intermediaries, to address concerns that the hard close would adversely affect investors that use such intermediaries. To address market timing, SEC is proposing that funds make greater disclosure of market timing, securities pricing, and portfolio disclosure policies. GAO supports these steps and encourages regulators to educate investors about the importance of such disclosures.

To improve mutual fund corporate governance and oversight, SEC has also proposed increasing the proportion of independent directors to 75 percent and to require independent chairs. SEC is also proposing that fund advisers appoint compliance officers that report to fund boards. GAO sees these actions as giving increased prominence to independent members on fund boards of directors and providing them with additional tools to effectively oversee fund practices. However, additional actions may be needed to ensure that independent directors have no relationships with the fund adviser or its personnel that could impair their independence. SEC and other regulators have also proposed that the broker-dealers that sell fund shares make more extensive disclosures about payments they receive from fund advisers. SEC is also seeking comments on how to revise the fees they charge investors that also compensate broker-dealers for selling fund shares. GAO supports these actions as increasing the transparency of these costs to investors but recognizes that the effectiveness of these proposals could be enhanced by expanded compliance and investor education programs.

SEC is also seeking information on how fund advisers use investor dollars to obtain research under a practice called soft dollars. Given the increased spotlight that Congress and regulators are placing on the mutual fund industry, GAO believes the time is right to more effectively address the conflicts of interest created by soft-dollar arrangements. In addition, GAO identifies further actions that could be taken to improve disclosure of mutual fund fees to enhance competition among funds on the basis of the fees that are charged to shareholders.

Mr. Chairman and Members of the Committee:

I am pleased to be here today to discuss GAO's work assessing the transparency of mutual fund fees and other fund practices and to discuss the various proposed or anticipated regulatory reforms designed to improve the management and sale of mutual funds. In the last 20 years, mutual funds have grown from under $400 billion to over $7.5 trillion in assets and have become a vital component of the financial security of the more than 95 million American investors estimated to own mutual funds. These funds have also grown to represent a significant portion of American's retirement wealth with 21 percent of the more than $10 trillion in pension plan assets now invested in mutual funds.[1] As a result, ensuring that mutual funds have sound governance and trading practices has never been more important. Recent actions by the Securities and Exchange Commission (SEC) and NASD would establish new procedures to protect shareholders against recently disclosed abusive trading practices, revise the structure and duties of the boards of directors that oversee funds, and place new responsibilities on the mutual fund and brokerage industries.[2]

Based on the work that we have performed over the last year, I will discuss problems we have seen within the mutual fund and brokerage industries and provide our views on the various SEC and NASD-proposed regulatory reforms.[3] Specifically, I will discuss proposed and final rules involving (1) fund pricing and compliance practices intended to address various mutual fund trading abuses that have come to light recently, (2) fund boards' independence and effectiveness, and (3) fund advisers compensation of broker-dealers that sell fund shares. In addition I will discuss additional actions regulators could take to further improve transparency and investor understanding of the fees they pay.

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[1]These statistics were reported by the Investment Company Institute and the Federal Reserve Board.

[2]NASD oversees broker-dealers that sell mutual funds and other securities to their customers.

[3]See U.S. General Accounting Office, *Mutual Funds: Information on Trends in Fees and Their Related Disclosure*, GAO-03-551T (Washington, D.C.: Mar. 12, 2003); *Mutual Funds: Greater Transparency Needed in Disclosures to Investors*, GAO-03-763 (Washington, D.C.: June 9, 2003); *Mutual Funds: Additional Disclosures Could Increase Transparency of Fees and Other Practices*, GAO-03-909T (Washington, D.C.: June 18, 2003); and *Mutual Funds: Additional Disclosures Could Increase Transparency of Fees and Other Practices*, GAO-04-317T (Washington, D.C.: Jan. 27, 2004).

In summary, we commend SEC and other regulators for their swift regulatory response to recent revelations of abusive mutual fund trading practices. We believe that many of the actions taken will provide the proper incentives to industry participants to follow sound practices and also provide regulators with additional compliance and enforcement tools to ensure that participants are held accountable for their behavior. However, some proposed actions need to be thoroughly assessed to ensure equitable treatment for all investors. In particular, while we agree that SEC's proposal to address late trading abuses with a hard 4:00 p.m. close provides increased certainty of the legitimacy of orders, we also recognize that there are wide-ranging and divergent interests in today's marketplace that must be accommodated to ensure that all retail and institutional investors are treated fairly. As such, while we agree with SEC's proposal for addressing unlawful late trading in the short run, we believe that SEC should continue to work with the retirement plan community and cognizant federal agencies to address concerns that this proposed rule may have certain adverse implications for certain participants in retirement savings plans.

We also firmly agree with SEC's proposals to enhance the independence and effectiveness of mutual fund boards. Giving increased prominence to independent members on fund boards of directors and providing them with additional tools to effectively oversee fund practices should go a long way to improve the system of checks and balances needed to avoid future trading abuses. However, additional attention could be afforded to ensuring the adequacy of the definition of an "interested person" to ensure that directors designated as independent directors are truly independent. We also recognize that other proposals for improving disclosures of mutual fund and brokerage trading practices will need to be reinforced with enhanced compliance, enforcement, and investor education programs if they are to be truly effective.

There are also other areas that warrant SEC's continued attention. SEC is seeking information on how mutual fund investors pay for advice from broker-dealers and how fund advisers use investor's dollars to obtain research. However, given the increased spotlight Congress and regulators are placing on the mutual fund industry, in our view, the time is right to address various conflicts of interest created by soft-dollar arrangements. In addition, further actions could be taken to improve disclosure of mutual fund fees to enhance competition among funds on the basis of the fees that are charged to shareholders.

In addition to the work I am discussing today, we are currently studying other issues related to the security of workers' retirement benefits. Pensions and retirement savings plans are an important source of income for millions of retirees. As such, we are reviewing how retirement savings plans, such as 401(k) plans, have been affected by the mutual fund late trading and market timing scandals, and how SEC's proposed rules to address these practices might affect plan participants and plan administration. On the broader issue of corporate governance, we also are currently studying what actions pension plan fiduciaries take to address conflicts of interest in connection with proxy voting issues. As large institutional shareholders, pension plans have the opportunity to influence governance of funds and hold company managers accountable for the business decisions they make.

Regulators Are Taking Actions to Address Abusive Mutual Fund Practices

In reaction to allegations of widespread misconduct and abusive practices involving mutual funds, regulators have responded with various proposals. In early September 2003, the Attorney General of the State of New York filed charges against a hedge fund manager for arranging with several mutual fund companies to improperly trade in fund shares and profit at the expense of other fund shareholders.[4] Since then, widening federal and state investigations of illegal late trading and improper timing of fund trades have involved a growing number of prominent mutual fund companies and brokerage firms.

Late Trading and Market Timing Are Detrimental to Fund Long-Term Shareholders

One of the abuses that has come to light recently is late trading. Under current rules, funds accept orders to sell and redeem fund shares at a price based on the current net asset value, which most funds calculate once a day at 4:00 p.m. Eastern Time.[5] Many investors, however, purchase mutual fund shares through other intermediaries such as broker-dealers, banks, and retirement savings plans. Instead of submitting hundreds or even thousands of individual purchase and redemption orders each day, these

[4]The term "hedge fund" generally identifies an entity that holds a pool of securities and perhaps other assets that does not register its securities offerings under the Securities Act and which is not registered as an investment company under the Investment Company Act of 1940. Hedge funds are also characterized by their fee structure, which compensates the adviser based upon a percentage of the hedge fund's capital gains and capital appreciation.

[5]SEC rule 22c-1, promulgated under the Investment Company Act of 1940, prohibits the purchase or sale of mutual fund shares except at a price based on current net asset value of such shares that is next calculated after receipt of a buy or sell order.

intermediaries typically aggregate orders received from investors and submit a single purchase or redemption order that nets all the individual shares their customers are seeking to buy or sell. Because this processing takes time, SEC rules permit these intermediaries to forward the order information to funds after 4:00 p.m.

However, late trading occurs when some investors are able to illegally purchase or sell mutual fund shares after the 4:00 p.m. Eastern Time close of U.S. securities markets, the time at which funds typically price their shares. An investor permitted to engage in late trading could be buying or selling shares at the current day's 4:00 p.m. price with knowledge of developments in the financial markets that occurred after 4:00 p.m. Such investors thus have unfair access to opportunities for profit that are not provided to other fund shareholders.

The extent to which some investors were allowed to submit late trading orders may have been significant. In September 2003, SEC sought information from fund advisers and broker-dealers about their pricing of mutual fund orders and late trading policies. SEC's preliminary analysis of this information showed that more than 25 percent of the 34 major broker-dealers that responded had customers that still received that day's price for orders they had placed or confirmed after 4:00 p.m. As of March 1, 2004, SEC had formally announced seven enforcement cases involving broker-dealers and other firms that were allegedly involved in late trading schemes; other cases may be forthcoming. We will be initiating a review of the adequacy of SEC's enforcement efforts and the sanctions that it can and has applied in these cases and will be reporting separately on these issues later this year. In addition, legislation is under consideration in the House of Representatives that will expand SEC's enforcement capabilities by raising the civil penalties for securities law violations, enhance the investigative procedures available to SEC, and streamline the process by which fines are disbursed among injured parties.[6]

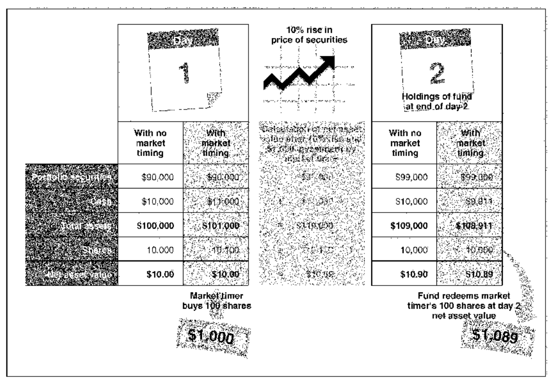
Another abuse that has come to light is known as market timing. Market timing occurs when certain fund investors place orders to take advantage of temporary disparities between the share value of a fund and the values of the underlying assets in the fund's portfolio. For example, U.S. mutual funds that use the last traded price for foreign securities (whose markets close hours before the U.S. markets) to value their portfolio when the U.S.

[6]See H.R. 2179, *Securities Fraud Deterrence and Investor Restitution Act of 2003.*

markets close could create opportunities for market timing if events that subsequently occurred were likely to cause significant movements in the prices of those foreign securities when their home markets reopen.

Market timing, although not currently illegal, can be unfair to long-term fund investors because it provides the opportunity for selected fund investors to profit from fund assets at the expense of long-term investors. The following example illustrates how market timing transactions can reduce the return to long-term shareholders of a fund.

Figure 1: Impact on Fund Net Asset Value (NAV) With and Without an Investment By a Market Timer



Source: GAO.

Note: The figure shows how a hypothetical mutual fund is affected by an increase in its portfolio assets with and without a market timer transaction. In this example, a market timer invests $1,000 in the fund on day 1 before a 10 percent rise in the value of the securities held by the fund. On day 2 the market timer redeems the shares yielding a reduction in the fund's net asset value compared to its value without a market timer transaction. The example assumes that the portfolio manager is unable to invest the market timer's cash and thus that amount does not help increase the fund's gain when the market rises.

As shown in the figure, the loss to long-term holders of the fund in this case is only $.01 per share. Although the amount by which a single market timing transaction reduces a fund's overall return can be small, repeated and large transactions over long periods of time can have a greater

cumulative effect. For example, one fund company whose staff were accommodating market timing transactions by 10 different investors estimated that these investors earned $22.8 million through their trading and that these activities costs its funds $2.7 million over a period of several years. In addition, the redemption fees that these investors should have paid but did not, amounted to another $5 million.

Market timing may also have been widespread. According to testimony by SEC's Director of Enforcement, although most mutual funds have policies that discourage market timing, this strategy was popular among some individuals and institutional traders who attempted to conceal their identities from fund companies. He also stated that 30 percent of the broker-dealers responding to an SEC information request reported assisting customers in attempting to conduct market timing trades, by using methods, such as breaking their orders into smaller sizes to avoid detection by the fund companies. Of the twelve cases SEC formally opened that involved market timing activities, including five cases that also involved late trading, two have been settled. In the settlement for one case that involved both late trading and market timing, SEC ordered the firm to pay fines and disgorgements of $225 million. In the other case, SEC ordered the firm to pay $250 million in fines and disgorgements. NASD also has taken various enforcement cases against broker-dealers involving late trading and market timing, including one in which a broker-dealer was fined $1 million and ordered to provide restitution of more than $500,000 for failing to prevent market timing of an affiliated firm's mutual funds.

Additional abusive practices associated with mutual funds have also come to light. To facilitate late trading and market timing arrangements, some fund advisers selectively disclosed information about their funds' portfolio holdings to outsiders. They also allowed these parties to late trade or conduct market timing in their funds. For example, in one SEC case a fund manager allowed a hedge fund to engage in market timing in a fund that he managed. The fund manager also disclosed portfolio information to a broker that enabled brokerage customers to conduct market timing transactions in the funds. In another state-administered case, a hedge fund executive obtained special trading privileges from several mutual fund companies that allowed him to engage in late trading and market timing in those funds.

Rule Changes Could Prevent Late Trading and Discourage Market Timing, but Some Investors Might Be Disadvantaged

In addition to enforcement actions, SEC has also proposed amending regulatory rules to address late trading, market timing, and selective disclosure abuses. In December 2003, SEC proposed amending the rule that governs how mutual funds price their shares and receive orders for share purchases or sales. [7] Since many of the cases of late trading involved orders submitted through intermediaries, including banks and pension plans not regulated by SEC, the proposed amendments to its rules would require that orders to purchase or redeem mutual fund shares be received by a fund, its transfer agent, or a registered clearing agency before the time of pricing (that is, 4:00 p.m. Eastern Time).[8]

Many organizations that purchase mutual fund shares, particularly those that administer retirement savings plans, have expressed concerns that such a "hard close" would unfairly prohibit some of their participants from receiving the same day's price on share purchases. Because intermediaries generally combine individual investor orders and submit single orders to funds to buy or sell, many officials at such firms are concerned that the time required to complete this processing will not allow them to meet the 4:00 p.m. deadline. In such cases, investors purchasing shares from Western states or through intermediaries would either have to submit their trades earlier than other investors in order to receive the current day's price or receive the next day's price. A letter commenting on SEC's proposal from two investor advocacy groups indicated that implementing the hard close would relegate some retail investors to the status of "second-class shareholders." Some plan sponsor organizations and plan record keepers have also raised concerns about the potential significant administrative costs associated with adopting systems to accommodate the 4:00 p.m. hard close and other proposed rules.

Because the hard close could affect some investors' ability to trade at the current day's price, some groups have called on SEC to allow industry participants to develop systems of internal controls that would serve to ensure that intermediaries receive individual orders before 4:00 p.m. With such controls in place, these orders could continue to be processed after

[7]Securities and Exchange Commission, Proposed Rule: Amendments to Rules Governing Pricing of Mutual Fund Shares, Release No. IC-26288 (Dec. 11, 2003).

[8]A fund's transfer agent maintains records of fund owners. Currently, the National Securities Clearing Corporation, which is the clearing organization for securities trades in the United States, also operates a system used by broker-dealers and others to transmit mutual fund orders to fund companies.

this time. However, SEC officials told us that they were skeptical that any system that relies on internal controls could not provide certainty that late trading was not occurring because many of the late trading abuses happened at firms that purportedly had such controls in place. However, SEC remains open to the possibility of the development of systems that could reasonably detect and deter late trading. In its proposals, SEC requests comments on various approaches designed to prevent late trading. Such protections could include a system that provides an electronic or physical time-stamp on orders. Other possible controls could include certifications that the intermediary had policies and procedures in place designed to prevent late trades, or audits by independent public accountants. Because multiple regulators oversee the operations of these financial intermediaries, any assessment of the reasonableness of recommended systems or controls would likely require effective coordination.

SEC is also proposing to take actions to address market timing. On December 11, 2003, SEC released a rule proposal to provide greater transparency to funds' market timing policies. Specifically, SEC would require mutual funds to disclose in their prospectuses the risks to shareholders of the frequent purchase and redemption of investment company shares, and fund policies and procedures pertaining to frequent purchases and redemptions. The proposal also would require funds to explain both the circumstances under which they would use fair value pricing and the effects of using fair value pricing.[9] Another rule will require funds to adopt fair value pricing policies that require funds among other things, to monitor for circumstances that may necessitate the use of fair value pricing, establish criteria for determining when market quotations are no longer reliable for a particular portfolio security, and provide a methodology or methodologies by which the funds determine the current fair value of portfolio securities. Also, SEC is seeking comment in one of its proposals for additional ways to improve the implementation of fair value pricing. In addition, the proposal would require funds to disclose policies and procedures pertaining to their disclosing information on the funds' portfolio holdings, and any ongoing arrangements to make available information about their portfolio securities. These additional disclosures would enable investors to better assess risks, policies, and procedures,

[9]Fair value pricing is a process that mutual funds use to value fund shares (such as for assets traded in foreign markets) in the absence of current market values. The Investment Company Act of 1940 requires that when market quotations for a portfolio security are not readily available, a fund must calculate its fair value.

and determine if a fund's policies and procedures were in line with their expectations. Disclosure of a fund's procedures in these areas would also allow SEC to better examine a fund's compliance with its stated procedures and hold fund managers accountable for their actions.

To further stem market timing, on March 3, 2004, SEC issued a proposed new rule to require mutual funds to impose a 2-percent redemption fee on the proceeds of shares redeemed within 5 business days of purchase. According to the proposal, the proceeds from the redemption fees would be retained by the fund, becoming a part of fund assets. In addition, the proposal addresses the pass thru of information from omnibus accounts maintained by intermediaries. Specifically, the proposal identifies three alternatives for funds to ensure that redemption fees are imposed on the appropriate market timers through the use of Taxpayer Identification Numbers. On at least a weekly basis intermediaries would be required to provide to the fund, purchase and redemption information for each shareholder within an omnibus account to enable the fund to detect market timers and properly assess redemption fees. The rule is designed to require short-term shareholders to reimburse funds for costs incurred as a result of investors using short-term trading strategies, such as market timing. The proposal would also include an emergency exception that would allow an investor not to pay a redemption fee in the event of an unanticipated financial emergency.

Unlawful late trading and certain market timing activities, which are not currently illegal, can be unfair to long-term investors because these activities provide the opportunity for selected fund investors to profit from fund assets at the expense of fund long-term investors. SEC's proposal to address late trading with a hard 4:00 p.m. close appears, in the short-term, to be the solution that provides the most certainty that all orders being submitted to the funds legitimately deserve that day's price. However, we also recognize that this action could have a significant impact on many investors, particularly those in employer-based retirement savings plans, who own fund shares through financial intermediaries. As a result, we urge the Commission to, as a supplement to their planned action, explore alternatives to the hard 4:00 p.m. close more fully and to revisit formally the question of how best to prevent late trading. Since some of the financial intermediaries involved are either overseen by other regulators or, in the case of third-party pension plan administrators, not overseen by any regulator, any such assessment should include the development of a strategy for overseeing the intermediary processing of mutual fund trades. Having a sound strategy for oversight of the varied participants in the

mutual fund industry would ensure that all relevant entities are held equally accountable for compliance with all appropriate laws.

We also commend SEC for proposing to require that mutual funds more fully disclose their market timing and portfolio disclosure policies. By increasing the transparency of these policies, industry participants will have the incentive to ensure that their policies are sound and will provide investors with information that they can use to distinguish between funds on the basis of these policies. The disclosures will also provide regulators and others with information to hold these firms accountable for their actions. However, such disclosures would likely also require improving related investor education programs to better ensure that investors understand the importance of these new disclosures. We also support SEC's redemption fee proposal as a means of discouraging market timing. Placing the proceeds of the fee back in the fund itself helps to ensure that the actions of short-term traders do not financially harm long-term investors, including pension plan participants who hold such funds.

Regulators Are Taking Actions to Improve the Effectiveness of Mutual Fund Boards of Directors

Mutual fund boards of directors have a responsibility to protect shareholder interests and SEC has issued various proposals to increase the effectiveness of these bodies. In particular, independent directors, who are not affiliated with the investment adviser, play a critical role in protecting mutual fund investors. To improve the independence of fund boards, SEC has issued various proposals to alter the structure of these boards and task them with additional duties.

Directors Have a Role in Overseeing Fees

Because the organizational structure of a mutual fund can create conflicts of interest between the fund's investment adviser and its shareholders, the law governing U.S. mutual funds requires funds to have a board of directors to protect the interests of the fund's shareholders. A fund is usually organized by an investment management company or adviser, which is responsible for providing portfolio management, administrative, distribution, and other operational services. In addition, the fund's officers are usually provided, employed, and compensated by the investment adviser. The adviser charges a management fee, which is paid with fund assets, to cover the costs of these services. With the management fee representing its revenue from the fund, the adviser's desire to maximize its revenues could conflict with shareholder goals of reducing fees. As one safeguard against this potential conflict, the Investment Company Act of 1940 (the Investment Company Act) requires mutual funds to have boards of directors to oversee shareholder interests. These boards must also

include independent directors who are not employed by or affiliated with the investment adviser.

As a group, the directors of a mutual fund have various responsibilities and in some cases, the independent directors have additional duties. In particular, the independent directors also have specific duties to approve the investment advisory contract between the fund and the investment adviser and the fees that will be charged. Specifically, section 15 of the Investment Company Act requires that the terms of any advisory contracts and renewals of advisory contracts be approved by a vote of the majority of the independent directors.

Under section 36(b) of the Investment Company Act, investment advisers have a fiduciary duty to the fund with respect to the fees they receive, which under state common law typically means that the adviser must act with the same degree of care and skill that a reasonably prudent person would use in connection with his or her own affairs. Section 36(b) also authorizes actions by shareholders and SEC against an adviser for breach of this duty. Courts have developed a framework for determining whether an adviser has breached its duty under section 36(b), and directors typically use this framework in evaluating advisory fees. This framework finds its origin in a Second Circuit Court of Appeals decision, in which the court set forth the factors relevant to determining whether an adviser's fee is excessive.[10] The court in this case stated that to be guilty of a breach under section 36 (b), the fee must be "so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arms-length bargaining." The standards developed in this case, and in cases that followed, served to establish current expectations for fund directors with respect to fees. In addition to potentially considering how a fund's fee compared to those of other funds, this court indicated that directors might find other factors more important, including

- the nature and quality of the adviser's services,
- the adviser's costs to provide those services,

[10] *Gartenberg v. Merrill Lynch Asset Management Inc.*, 528 F. Supp. 1038 (S.D.N.Y. 1981), *aff'd*, 694 F. 2d 923 (2d Cir. 1982), *cert. denied, 461 U.S. 906(1983).*

- the extent to which the adviser realizes and shares with the fund economies of scale as the fund grows,
- the volume of orders that the manager must process,
- indirect benefits to the adviser as the result of operating the fund, and
- the independence and conscientiousness of the directors.

Concerns Over Directors' Roles Exist

Some industry experts have criticized independent directors for not exercising their authority to reduce fees. For example, in a speech to shareholders, one industry expert stated that mutual fund directors have failed in negotiating management fees. The criticism arises in part from the annual contract renewal process, in which boards compare fees of similar funds. However, the directors compare fees with the industry averages, which the experts claim provides no incentive for directors to seek to lower fees. Another industry expert complained that fund directors are not required to ensure that fund fees are reasonable, much less as low as possible, but instead are only expected to ensure that fees fall within a certain range of reasonableness.

In contrast, an academic study we reviewed criticized the court cases that have shaped directors' roles in overseeing mutual fund fees. The authors noted that these cases generally found that comparing a fund's fees to other similar investment management services, such as pension plans, was inappropriate as fund advisers do not compete with each other to manage a particular fund. Without being able to compare fund fees to these other products, the study's authors say that investors bringing these cases lacked sufficient data to show that a fund's fees were excessive.[11]

Various Actions Taken or Proposed to Increase Board Effectiveness and Mutual Fund Oversight

In light of concerns over director roles and effectiveness, including concerns arising from the recently alleged abusive practices, SEC has taken various actions to improve board governance and strengthen the compliance programs of fund advisers. To strengthen the hand of independent directors when dealing with fund management, SEC issued a proposal in January 2004 to amend rules under the Investment Company

[11] J.P. Freeman and S.L. Brown, "Mutual Fund Advisory Fees: The Cost of Conflicts of Interest," *26 Journal of Corporation Law 609* (2001).

Act to alter the composition and duties of many fund boards.[12] These reforms include

- requiring an independent chairman for fund boards of directors;
- increasing the percentage of independent directors from a majority to at least seventy-five percent of a fund's board;
- requiring fund independent directors to meet at least quarterly in a separate session; and
- providing the independent directors with authority to hire employees and others to help the independent directors fulfill their fiduciary duties.

Under the Investment Company Act, only individuals who are not "interested" can serve as independent directors. Section 2(a)(19) of the Investment Company Act defines the term "interested person" to include the fund's investment adviser, principal underwriter, and certain other persons (including their employees, officers or directors) who have a significant relationship with the fund, its investment adviser or principal underwriter. Broker-dealers that distribute the fund's shares or persons who have served as counsel to the fund would also be considered interested. However, SEC has suggested that Congress give it authority to fill gaps in the statute that have permitted persons to serve as independent directors who do not appear to be sufficiently independent of fund management. For example, the statute permits a former executive of the fund's adviser to serve as an independent director two years after the person has retired from his position. This permits an adviser to use board positions as a retirement benefit for its employees. The statute also permits relatives of fund managers to serve as independent directors as long as they are not members of the "immediate family" or affiliated persons of the fund. In one case, SEC found that an uncle of the funds portfolio manager served as an independent director of the fund. Giving SEC additional rulemaking authority to define the term "interested person" clearly seems appropriate.

As part of their proposal to alter the structure of fund boards, SEC is also proposing that fund directors perform at least once annually an evaluation

[12] Securities and Exchange Commission, Proposed Rule: Investment Company Governance, Release No. IC-26323 (Jan.15, 2004).

of the effectiveness of the board and its committees. This evaluation is to consider the effectiveness of the board's committee structure and whether the directors have taken on the responsibility for overseeing too many funds. The proposal also seeks to amend the fund recordkeeping rule (rule 31a-2) to require that funds retain copies of the written materials that directors consider in approving an advisory contract under section 15 of the Investment Company Act.

According to the SEC proposal, the changes to board structure and authority are designed to enhance the independence and effectiveness of fund boards and to improve their ability to protect the interests of the funds and fund shareholders they serve. Specifically, SEC noted that commenters on a 2001 amendment believed that a supermajority of independent directors would help to strengthen the hand of independent directors when dealing with fund management, and help assure that independent directors maintain control of the board in the event of illness or absence of other independent directors. Also, SEC concluded that (1) a boardroom culture favoring the long-term interests of fund shareholders might be more likely to prevail if the board chairman does not have the conflicts of interest inherent in his role as an executive of the fund adviser, and (2) a fund board may be more effective when negotiating with the fund adviser over matters such as the advisory fee if it were not led by an executive of the adviser with whom it was negotiating. SEC also noted that separate meetings of the independent directors would afford independent directors the opportunity for frank and candid discussion among themselves regarding the management of the fund. In addition, it saw the use of staff and experts as important to help independent directors deal with matters beyond their level of expertise and give them an understanding of better practices among mutual funds.

According to SEC's proposal, having fund directors perform self-evaluations of the boards' effectiveness could improve fund performance by strengthening the directors' understanding of their role and fostering better communication and greater cohesiveness. This would focus the board's attention on the need to create, consolidate, or revise various board committees such as the audit, nominating, or pricing committees. Finally, according to SEC staff, the proposed additional recordkeeping rule would allow compliance examiners to review the quality of the materials that boards considered in approving advisory contracts.

In response to concerns regarding the adequacy of fund board review of advisory contracts and management fees, on February 11, 2004, SEC also released proposed rule amendments to require that funds disclose in

shareholders reports how boards of directors evaluate and approve, and recommend shareholder approval of investment, advisory contracts. The proposed amendments would require a fund to disclose in its reports to shareholders the material factors and the conclusions with respect to those factors that formed the basis for the board's approval of advisory contracts during the reporting period. The proposals also are designed to encourage improved disclosure in the registration statement of the basis for the board's approval of existing advisory contracts, and in proxy statements of the basis for the board's recommendation that shareholders approve an advisory contract.

In addition, to facilitate better board governance and oversight, SEC adopted requirements to ensure that mutual funds and advisers have internal programs to enhance compliance with federal securities laws and regulations. On December 17, 2003, SEC adopted a new rule that requires each investment company and investment adviser registered with the Commission to

- adopt and implement written policies and procedures reasonably designed to prevent violation of the federal securities laws,
- review those policies and procedures annually for their adequacy and the effectiveness of their implementation, and
- designate a chief compliance officer to be responsible for administering the policies and procedures.

In the case of an investment company, the chief compliance officer would report directly to the fund board. These rules are designed to protect investors by ensuring that all funds and advisers have internal programs to enhance compliance with federal securities laws.

To ensure that fund investment adviser officials and employees are aware of and held accountable for their fiduciary responsibilities to their fund shareholders, SEC also released a rule proposal in January 2004 that would require registered investment adviser firms to adopt codes of ethics. According to the proposal, the rule was designed to prevent fraud by reinforcing fiduciary principles that must govern the conduct of advisory firms and their personnel. The proposal states that codes of ethics remind employees that they are in a position of trust and must act with integrity at all times. The codes would also direct investment advisers to establish procedures for employees, so that the adviser would be able to determine whether the employee was complying with the firm's principles.

In addition to these actions, SEC had previously adopted rules that became effective in April 2003 that require funds to disclose on a quarterly basis how they voted their proxies for the portfolio securities they hold. SEC also required client proxies to adopt policies and procedures reasonably designed to ensure that the adviser votes proxies in the best interests of clients, to disclose to clients information about those policies and procedures, to disclose to clients how they may obtain information on how the adviser voted their proxies, and to maintain certain records relating to proxy voting. In adopting these requirements, SEC noted that this increased transparency would enable fund shareholders to monitor their funds' involvement in the governance activities of portfolio companies, which may have a dramatic impact on shareholder value. We are currently reviewing whether pension plans have similar requirements to disclose their proxy voting activities to their participants and will be reporting separately on these issues later this year.

In our view, these SEC proposals should help ensure that mutual fund boards of directors are independent and take an active role in ensuring that their funds are managed in the interests of their shareholders. Many fund boards already meet some of these requirements, but SEC's proposal will better ensure that such practices are the norm across the industry. Although such practices do not guarantee that funds will be well managed and will avoid illegal or abusive behavior, greater board independence could promote board decision making that is aligned with shareholders' interests and thereby enhance board accountability. While board independence does not require eliminating all nonindependent directors, we have taken the position in previous work that it should call for a supermajority of independent directors.[13] Our prior work also recognized that independent leadership of the board is preferable to ensure some degree of control over the flow of information from management to the board, scheduling of meetings, setting of board agendas, and holding top management accountable. To further ensure that board members are truly independent, we would support the Congress giving SEC rulemaking authority to specify the types of persons who qualify as "interested persons." Having compliance officers report to fund boards and having advisers implement codes of ethics should also provide additional tools to hold fund advisers and boards accountable for ensuring that all fund

[13]U.S. Comptroller General David M. Walker, Integrity: Restoring Trust in American Business and the Accounting Profession (document based on author's speech to the American Institute of Certified Public Accountants), Nov. 2002.

activities are conducted in compliance with legal requirements and with integrity.

Regulators Have Responded to Broker-Dealer Compensation Issues

In addition to addressing alleged abusive practices, securities regulators are also introducing proposals that respond to concerns over how broker-dealers are compensated for selling mutual funds. Specifically, SEC is seeking comments on how to revise a rule that allows mutual funds to deduct fees to pay for the marketing and sale of fund shares. In addition, to address a practice that raises potential conflicts of interest between broker-dealers and their customers, SEC and NASD have also proposed rules that would require broker-dealers to disclose revenue sharing payments that fund advisers make to broker-dealers to compensate them for selling fund shares. SEC has also recently proposed banning a practice called directed brokerage that, if adopted, would prohibit funds from using trading commissions as an additional means of compensating broker-dealers for selling their funds.

12b-1 Fees Have Increased Investor Choice but Alternatives Could Provide Additional Benefits

Approximately 80 percent of mutual fund purchases are made through broker-dealers or other financial professionals, such as financial planners and pension plan administrators. Prior to 1980, the compensation that these financial professionals received for assisting investors with mutual fund purchases was paid either by charging investors a sales charge or load or paying for such expenses out of the investment adviser's own profits. However, in 1980, SEC adopted rule 12b-1 under the Investment Company Act to help funds counter a period of net redemptions by allowing them to use fund assets to pay the expenses associated with the distribution of fund shares. Under NASD rules, 12b-1 fees are limited to a maximum of 1 percent of a fund's average net assets per year.[14]

Although originally envisioned as a temporary measure to be used during periods when fund assets were declining, the use of 12b-1 fees has evolved to provide investors with flexibility in paying for investment advice and purchases of fund shares. Instead of being offered only funds that charge a front-end load, investors using broker-dealers to assist them with their

[14]Specifically, NASD rules limits the amount of 12b-1 fees that may be paid to broker-dealers to no more than 0.75 percent of a fund's average net assets per year. Funds are also allowed to include an additional service fee of up to 0.25 percent of average net assets each year to compensate sales professionals for providing ongoing services to investors or for maintaining their accounts.

purchases can now choose from different classes of fund shares that vary by how the broker-dealer is compensated. In addition to shares that involve front-end loads with low or no 12b-1 fee—typically called Class A shares, investors can also invest in Class B shares that have no front-end load but instead charge an annual 1 percent 12b-1 fee paid a certain number of years, such as 7 or 8 years, after which the Class B shares would convert to Class A shares. Other share classes may have lower 12b-1 fees but charge investors a redemption fee—called a back-end load—if shares are not held for a certain minimum period. Having classes of shares allows investors to choose the share class that is most advantageous depending on how long they plan to hold the investment.[15]

Because 12b-1 fees are used in ways different than originally envisioned, SEC is seeking public comment on whether changes to rule 12b-1 are necessary. In a proposal issued on February 24, 2004, SEC staff noted that modifications might be needed to reflect changes in the manner in which funds are marketed and distributed. For example, SEC staff told us that rule 12b-1 requires fund boards when annually re-approving a fund's 12b-1 plan, to consider a set of factors that likely are not relevant in today's environment.

In the proposal, SEC also seeks comments on whether alternatives to 12b-1 fees would be beneficial. One such alternative would have distribution-related costs deducted directly from individual customer accounts rather than having fund advisers deduct fees from the entire fund's assets for eventual payment to selling broker-dealers. The amount due the broker-dealer could be deducted over time, say once a quarter until the total amount is collected.[16] According to the SEC proposal, this alternative would be beneficial because the amounts charged and their effect on shareholder value would be completely transparent to the shareholder because the amounts would appear on the shareholder's account

[15]Concerns over whether broker-dealers are helping investors choose the best type of fund shares for their needs have been raised recently. For example, in May 2003, SEC took an enforcement action against a major broker dealer that it accused of inappropriately selling mutual fund B shares to investors who would have been better off buying another class of shares.

[16]SEC's proposal provides an example where a shareholder purchasing $10,000 of fund shares with a 5-percent sales load could pay a $500 sales load at the time of purchase, or could pay an amount equal to some percentage of the value of his or her account each month until the $500 amount was fully paid (plus carrying interest). If the shareholder redeemed the shares before the amount was fully paid, the proceeds of the redemption would be reduced by the unpaid amount.

statements. According to a fund official and an industry analyst, having fund shareholders see the amount of compensation that their broker is receiving would increase investor awareness of such costs and could spur greater competition among firms over such costs.

We commend SEC for seeking comments on potentially revising rule 12b-1. Such fees are now being used in ways SEC did not intend when it adopted the rule in 1980. We believe providing alternative means for investors to compensate broker-dealers, like the one SEC's proposal describes, would preserve the beneficial flexibility that investors currently enjoy while also increasing the transparency of these fees. An approach like the one SEC describes would also likely increase competition among broker-dealers over these charges, which could lower the costs of investing in fund shares further.

Regulators Respond to Revenue Sharing Payment Concerns

Regulators have also acted to address concerns arising from another common mutual fund distribution practice called revenue sharing. Revenue sharing occurs when mutual fund advisers make payments out of their own revenue to broker-dealers to compensate them for selling that adviser's fund shares. Broker-dealers that have extensive distribution networks and large staffs of financial professionals who work directly with and make investment recommendations to investors, increasingly demand that fund advisers make these payments in addition to the sales loads and 12b-1 fees that they earn when their customers purchase fund shares. For example, some broker-dealers have narrowed their offerings of funds or created preferred lists that include the funds of just six or seven fund companies that then become the funds that receive the most marketing by these broker-dealers. In order to be selected as one of the preferred fund families on these lists, the mutual fund adviser often is required to compensate the broker-dealer firms with revenue sharing payments. According to an article in one trade journal, revenue sharing payments made by major fund companies to broker-dealers may total as much as $2 billion per year. According to the officials of a mutual fund research organization, about 80 percent of fund companies that partner with major broker-dealers make cash revenue sharing payments.

However, revenue sharing payments may create conflicts of interest between broker-dealers and their customers. By receiving compensation to emphasize the marketing of particular funds, broker-dealers and their sales representatives may have incentives to offer funds for reasons other than the needs of the investor. For example, revenue sharing arrangements might unduly focus the attention of broker-dealers on particular mutual

funds, reducing the number of funds considered as part of an investment decision—potentially leading to inferior investment choices and potentially reducing fee competition among funds. Finally, concerns have been raised that revenue sharing arrangements might conflict with securities self-regulatory organization rules requiring that brokers recommend purchasing a security only after ensuring that the investment is suitable for the investor's financial situation and risk profile.

Our June 2003 report recommended that SEC consider requiring that more information be provided to investors to evaluate these conflicts of interest; SEC and NASD have recently issued proposals to require such disclosure. Although broker-dealers are currently required to inform their customers about the third-party compensation the firm is receiving, they have generally been complying with this requirement by providing their customers with the mutual fund's prospectus, which discloses such compensation in general terms. On January 14, 2004, SEC proposed rule changes that would require broker-dealers to disclose to investors prior to purchasing a mutual fund whether the broker-dealer receives revenue sharing payments or portfolio commissions from that fund adviser as well as other cost-related information. Similarly, NASD has proposed a change to its rules that would require broker-dealers to provide written disclosures to a customer when an account is first opened or when mutual fund shares are purchased that describe any compensation that they receive from fund advisers for providing their funds "shelf space" or preference over other funds. SEC is also proposing that broker-dealers be required to provide additional specific information about the revenue sharing payments they receive in the confirmation documents they provide to their customers to acknowledge a purchase. This additional information would include the total dollar amount earned from a fund's adviser and the percentage that this amount represented of the total sales by the broker-dealer of that advisers' fund shares over the 4 most recent quarters.

We commend SEC and NASD for taking these actions. The disclosures being proposed by SEC and NASD are intended to ensure that investors have information that they can use to evaluate the potential conflicts their broker-dealer may have when recommending particular fund shares to investors. However, such disclosures would likely also require improving related investor education programs to better ensure that investors understand the importance of these new disclosures.

SEC Has Also Proposed Eliminating Another Potential Mutual Fund Conflict

SEC has also taken another action to address a practice that creates conflicts of interest between fund shareholders and broker-dealers or fund advisers. On February 11, 2004, SEC proposed prohibiting fund advisers from using trading commissions as compensation to broker-dealers that sell their funds. Such arrangements are called "directed brokerage," in which fund advisers choose broker-dealers to conduct trades in their funds' portfolio securities as an additional way of compensating those brokers for selling fund shares. These arrangements represent a hidden expense to fund shareholders because brokerage commissions are paid out of fund assets, unlike revenue sharing, which is paid out of advisers' revenues. We support this action as a means of better ensuring that fund advisers choose broker-dealers based on their ability to effectively execute trades and not for other reasons.

Other Areas Requiring Continued SEC Attention

SEC is considering actions to address conflicts of interests created by "soft-dollar arrangements" and has taken actions to enhance disclosures related to the costs of owning mutual funds, including considering making more transparent costs included in brokerage transactions. Although SEC has taken some actions, we believe that additional steps could be taken to provide further benefits to investors by increasing the transparency of certain mutual fund practices and enhancing competition among funds on the basis of the fees that are charged to shareholders.

Soft Dollar Arrangements Provide Benefits, but Could Adversely Impact Investors

Soft dollar arrangements allow fund investment advisers to obtain research and brokerage services that could potentially benefit fund investors but also increase investor costs. When investment advisers buy or sell securities for a fund, they may have to pay the broker-dealers that execute these trades a commission using fund assets. In return for these brokerage commissions, many broker-dealers provide advisers with a bundle of services, including trade execution, access to analysts and traders, and research products.

Soft dollar arrangements are the result of regulatory changes in the 1970s. Until the mid-1970s, the commissions charged by all brokers were fixed at one equal price. To compete for commissions, broker-dealers differentiated themselves by offering research-related products and services to advisers. In 1975, to increase competition, SEC abolished fixed brokerage commission rates. However, investment advisers were concerned that they could be held in breach of their fiduciary duty to their clients to obtain best execution on trades if they paid anything but the lowest commission rate available to obtain research and brokerage

services. In response, Congress created a "safe harbor" under Section 28(e) of the Securities Exchange Act of 1934 that allowed advisers to pay more than the lowest available commission rate for security transactions in return for research and brokerage services. Although legislation provides a safe harbor for investment advisers to use soft-dollars, SEC is responsible for defining what types of products and services are considered lawful under the safe harbor. Since 1986, the SEC has interpreted Section 28(e) as applying to a broad range of products and services, as long as they provide 'lawful and appropriate assistance to the money manager in carrying out investment decision-making responsibilities.'

Some industry participants argue that the use of soft dollars benefits investors in various ways. The research that the fund adviser obtains can directly benefit fund investors if the adviser uses it to select securities for purchase or sale by the fund. The prevalence of soft dollar arrangements also allows specialized, independent research to flourish, thereby providing money managers a wider choice of investment ideas. As a result, this research could contribute to better fund performance. The proliferation of research available as a result of soft dollars might also have other benefits. For example, an investment adviser official told us that the research on smaller companies helps create a more efficient market for securities of those companies, resulting in greater market liquidity and lower spreads, which would benefit all investors including those in mutual funds.

Although the research and brokerage services that fund advisers obtain through the use of soft dollars could benefit a mutual fund investor, this practice also could increase investors' costs and create potential conflicts of interest that could harm fund investors. For example, soft dollars could cause investors to pay higher brokerage commissions than they otherwise would, because advisers might choose broker-dealers on the basis of soft dollar products and services, not trade execution quality. Soft dollar arrangements could also encourage advisers to trade more in order to pay for more soft dollar products and services. Overtrading would cause investors to pay more in brokerage commissions than they otherwise would. These arrangements might also tempt advisers to "over-consume" research because they would not be paying for it directly. In turn, advisers might have less incentive to negotiate lower commissions, resulting in investors paying more for trades.

Regulators also have raised concerns over soft dollar practices. In 1996 and 1997, SEC examiners conducted an examination sweep into the soft

dollar practices of broker-dealers, investment advisers, and mutual funds. In the resulting 1998 inspection report, SEC staff documented instances of soft dollars being used for products and services outside the safe harbor, as well as inadequate disclosure and bookkeeping of soft dollar arrangements. SEC staff told us that their review found that mutual fund advisers engaged in far fewer soft dollar abuses than other types of advisers. To address the concerns identified, the SEC staff report proposed recommending that investment advisers keep better records and make greater disclosure about their use of soft dollars. A working group formed in 1997 by the Department of Labor (DOL) to study the need for regulatory changes and additional disclosures to pension plan sponsors and fiduciaries on soft dollar arrangements recommended that SEC act to narrow the definition of products and services that are considered research and allowable under the safe harbor.[17] The working group also recommended that SEC prepare a specific list of acceptable purchases with soft dollars that included brokerage and research services.

Additional Actions to Address Conflicts Raised by Soft Dollars Could be Beneficial

Although SEC has acknowledged the concerns involved with soft-dollar arrangements, it has taken limited actions to date. SEC staff told us that the press of other business prevented them from addressing the issues raised by other regulators and their own 1998 staff report. However, in a December 2003 concept release on portfolio transaction costs staff requested comments on what types of information investment advisers should be required to provide to mutual fund boards regarding the allocation of brokerage commissions for execution purposes and soft dollar benefits.[18] In addition, SEC staff told us that they have formed a study group with representatives of the relevant SEC divisions, including Investment Management, Market Regulation, and the Office of Compliance Inspections and Examinations, to review soft dollar issues. This group also is collecting information from industry and foreign regulators.

Regulators in other countries and other industries have acted to address the conflicts created by soft dollars. In the United Kingdom, the Financial Services Authority (FSA), which regulates the financial services industry

[17] U.S. Department of Labor, *Report of the Working Group on Soft Dollars/Commission Recapture* (Nov. 13, 1997) available at http://www.dol.gov/ebsa/publications/softdolr.htm. DOL oversees pension plans.

[18] SEC's concept release "Measures to Improve Disclosure of Mutual Fund Transaction Costs" specifically requests comments on ways to improve the qualification and disclosure of commission costs as well as other transaction related costs.

in that country, has issued a consultation paper that argues that these arrangements create incentives for advisers to route trades to broker-dealers on the basis of soft dollar arrangements and that these practices represented an unacceptable market distortion.[19] As a result of recommendations from a government-commissioned review of institutional investment, FSA has proposed banning soft dollars for market pricing and information services, as well as various other products.[20] FSA notes that their proposal would limit the ability of fund managers to pass management costs through their customers' funds in the form of commissions and would provide more incentive to consider what services are necessary for efficient funds management, both of which could lower investor costs. However, FSA staff has acknowledged that restricting soft dollar arrangements in the United Kingdom could hurt the international competitiveness of their fund industry because fund advisers outside their country would not have to comply with these restrictions.

In addition, DOL has placed more restrictions on pension plan administrators use of soft dollars than apply to mutual fund advisers. SEC requires mutual fund boards of directors to review fund trading activities to ensure that the adviser is obtaining best execution and to monitor any conflicts of interest involving soft dollars. However, section 28(e) allows fund advisers to use soft dollars generated by trading in one fund's portfolio to obtain research that does not benefit that particular fund but instead benefits other funds managed by that adviser. In contrast, DOL requires plan fiduciaries to monitor the plan's investment managers to ensure that the soft dollar research obtained from trading commissions paid out of plan assets benefits the plan and that the benefits to the plan are reasonable in relation to the value of the brokerage and research services provided to the plan.

Some industry participants have also called on SEC to restrict soft dollar usage. For example, the board of the Investment Company Institute (ICI), which is the industry association for mutual funds, recently recommended that SEC consider narrowing the definition of allowable research under Section 28(e) and eliminate the purchase of third-party research with soft-dollars. According to statements released by ICI, SEC's definition of permitted research is overly expansive and has been susceptible to abuse.

[19]Financial Services Authority, *Bundled Brokerage and Soft Commission Arrangements* (April 2003).

[20]P. Myners, *Institutional Investment in the United Kingdom: A Review* (Mar. 6, 2001).

ICI recommends that SEC prohibit advisers from using soft dollars to obtain any products and services that are otherwise publicly available in the marketplace, such as periodical subscriptions or electronic news services. In a letter to the SEC Chairman, ICI wrote that its proposal would reduce incentives for investment advisers to engage in unnecessary trading and would more closely reflect the original purpose of Section 28(e), which was to allow investment advisers to take into account a broker-dealer's research capabilities in addition to its ability to provide best execution.

Beyond these proposals, some industry participants have called for a complete ban of soft dollars. If soft dollars were banned—which would require repeal of Section 28(e)—and bundled commission rates were required to be separately itemized, fund advisers would not be allowed to pay higher commissions in exchange for research. Advocates of banning soft dollars believe that this would spur broker-dealers to compete on the price of executing trades, which averages between \$.05 and \$.06 per share at large broker-dealers, whereas trades conducted through other venues can be done for \$.01 or less. Critics fear that this ban would reduce the amount of independent research that advisers obtain, which would hurt investors and threaten the viability of some existing independent research firms.

To address concerns over soft dollars, our June 2003 report recommends that SEC evaluate ways to provide additional information to fund directors and investors on their fund advisers' use of soft dollars. Because SEC has not acted to more fully address soft dollar-related concerns, investors and mutual fund directors have less complete and transparent information with which to evaluate the benefits and potential disadvantages of fund advisers' use of soft dollars. However, such disclosures could potentially increase the complexity of the information that investors are provided and require them to interpret and understand such information. As such, an enhanced investor education campaign would also likely be warranted.

Although disclosure can improve transparency, it may not be sufficient for creating proper incentives and accountability. In our view, the time for SEC to take bolder actions regarding soft dollars is now. Allowing the advisers of mutual funds to use customer assets to obtain services that would otherwise have to be paid for using advisers' revenues appears to create inappropriate incentives, and inadequate transparency and accountability.

We commend SEC for initiating an internal study of soft dollar issues. As part of this evaluation, we believe that SEC should consider at a minimum the merits of narrowing the services that are considered acceptable under the safe harbor. Concerns that SEC's current definition of permitted research is overly expansive and susceptible to abuse have been recognized for years. Acting to narrow the safe harbor could reduce opportunities for abusive practices. It could also lower investor costs by reducing adviser incentives to overtrade portfolio assets to obtain soft dollar research and services. We also believe that SEC's study should consider the relative merits of eliminating soft dollar arrangements altogether. The elimination of soft dollars, which would require legislative action, could create greater incentives for broker-dealers to compete on the basis of execution cost and greater incentives for fund advisers to weigh the necessity of some of the research they now receive since they would have to pay for such items from their own revenues.

New and Proposed Rules Could Provide Added Transparency of the Costs of Investing in Mutual Funds

SEC recently adopted rules and rule amendments aimed at increasing investor awareness by improving the disclosures of the fees and expenses paid for investing in mutual funds. In February 2004, SEC adopted rule amendments that require mutual funds to make additional disclosures about their expenses.[21] This information will be presented to investors in the annual and semiannual reports prepared by mutual funds. Among other things, mutual funds will now be required to disclose the cost in dollars associated with an investment of $1,000 that earned the fund's actual return and incurred the fund's actual expenses paid during the period. In addition to allowing existing investors to compare fees across funds, SEC staff indicated that placing these disclosures in funds' annual and semiannual reports will help prospective investors to compare funds' expenses before making a purchase decision.

In addition to this action, SEC amended fund advertising rules in September 2003 to require funds to state in advertisements that investors should consider a fund's fees before investing and direct investors to consult the fund prospectus for more information.[22] Additionally, in

[21]Securities and Exchange Commission, Final Rule: Shareholder Reports and Quarterly Portfolio Disclosure of Registered Management Investment Companies, Release Nos. 33-8393; 34-49333; IC-26372 (Feb. 27, 2004).

[22]Securities and Exchange Commission, Final Rule: Amendments to Investment Company Advertising Rules, Release Nos. 33-8294; 34-48558; IC-26195 (Sep. 29, 2003).

November 2003, NASD proposed amending rules to require that mutual funds advertising their performance present specific information about the fund's expenses and performance in a more prominent format. These new requirements are aimed at improving investor awareness of the costs of buying and owning a mutual fund, facilitating comparison of fees among funds, and make presentation of standardized performance information more prominent. Specifically, NASD's proposal would require that all performance advertising contain a text box that sets forth the fund's standardized performance information, maximum sales charge, and annual expense ratio. In doing so NASD's proposal would go beyond SEC requirements by requiring funds to include specific performance and expense information within advertising materials.

Another cost-related rulemaking initiative by SEC staff seeks to improve the disclosure of breakpoint discounts for front-end sales loads. In March 2003, SEC, NASD, and the New York Stock Exchange issued a report describing the failure of some broker-dealers to issue discounts on front-end charges paid to them by mutual fund investors. Mutual funds with front-end sales loads often offer investors discounts or "breakpoints" in these sales loads as the dollar value of the shares purchased by investors or members of their family increases, such as for purchases of $50,000 or more. To better ensure that investors receive these discounts when deserved, SEC is proposing to require funds to disclose in their prospectuses when shareholders are eligible for breakpoint discounts. According to the SEC proposal, such amendments are intended to provide greater prominence to breakpoint disclosure by requiring its inclusion in the prospectus rather than in the Statement of Additional Information, which is a document delivered to investors only upon request.

However, these actions would not require mutual funds to disclose to each investor the specific amount of fees in dollars that are paid on the shares they own. As result, investors will not receive information on the costs of mutual fund investing in the same way they see the costs of many other financial products and services that they may use. In addition, these actions do not require that mutual funds provide information relating to fees in the document that is most relevant to investors—the quarterly account statement. In a 1997 survey of how investors obtain information about their funds, ICI indicated that, to shareholders, the account statement is probably the most important communication that they receive from a mutual fund company and that nearly all shareholders use such statements to monitor their mutual funds.

Our June 2003 report recommends that SEC consider requiring mutual funds to make additional disclosures to investors, including considering requiring funds to specifically disclose fees in dollars to each investor in quarterly account statements. SEC has agreed to consider requiring such disclosures but was unsure that the benefits of implementing specific dollar disclosures outweighed the costs to produce such disclosures. However, we estimate that spreading these implementation costs across all investor accounts might not represent a large outlay on a per-investor basis.

Our report also discusses less costly alternatives that could also prove beneficial to investors and spur increased competition among mutual funds on the basis of fees. For example, one less costly alternative would require quarterly statements to present the same information—the dollar amount of a fund's fees based on a set investment amount—recently required for mutual fund semiannual reports. Doing so would place this additional fee disclosure in the document generally considered to be of the most interest to investors. An even less costly alternative would be to require that quarterly statements also include a notice that reminds investors that they pay fees and to check their prospectus and ask their financial adviser for more information. Disclosures such as these could be the incentive that some investors need to take action to compare their fund's expenses to those of other funds and thus make more informed investment decisions. Such disclosures may also increasingly motivate fund companies to respond competitively by lowering fees.

This concludes my prepared statement and I would be happy to respond to any questions at the appropriate time.

Contacts and Acknowledgements

For further information regarding this testimony, please contact Richard J. Hillman or Cody J. Goebel at (202) 512-8678. Individuals making key contributions to this testimony include Toayoa Aldridge, Barbara Roesmann, George Scott, and David Tarosky.

PREPARED STATEMENT OF LORI A. RICHARDS

DIRECTOR, OFFICE OF COMPLIANCE INSPECTIONS AND EXAMINATIONS
U.S. SECURITIES AND EXCHANGE COMMISSION

MARCH 10, 2004

Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee, thank you for inviting me to testify today on behalf of the Securities and Exchange Commission concerning our examinations of mutual funds. With more than 95 million Americans invested in mutual funds, representing tens of millions of households, and approximately $7 trillion in assets, mutual funds are a vital part of this Nation's economy. Millions of investors depend on mutual funds for their financial security. As Chairman Donaldson said when he testified before this Committee in November, mutual fund investors have a right to an investment industry that is committed to the highest ethical standards and that places investors' interests first. The Commission's regulatory and enforcement actions, as well as actions by State securities regulators, are intended to prevent and deter market timing and late trading abuses.

The Commission is responsible for examining mutual funds and their investment advisers. There are now some 8,000 funds, managed in over 900 fund complexes, and over 8,000 investment advisers. Until recently, the SEC had approximately 360 staff persons for these examinations. In 2003, budget increases allowed us to increase our staff for fund examinations by a third, to approximately 500 staff. The size of the mutual fund industry precludes a comprehensive audit of each registrant's operations by examination staff. Our routine examinations, therefore, focus on those areas that, in our view, pose the greatest risk to investors.

Examinations identify compliance problems at individual firms, and also help to identify areas of emerging compliance risk. In recent years, for example, examiners have identified and Commission staff have addressed a number of practices that may harm investors, including, for example, abusive soft-dollar arrangements, favoritism in the allocation of investments, misrepresentations and omissions in the sales of fund shares, inaccurate pricing of fund shares, the failure to obtain best execution in portfolio transactions, sales practice abuses in the distribution of different classes of mutual fund shares, and the failure to give customers the discounts generally available on the large purchases of fund shares—these discounts are known as "breakpoints."

The Commission examiners, along with enforcement staff, are actively conducting examinations and investigations of a large number of market participants to determine whether they engaged in abusive and undisclosed market timing and late trading in fund shares. The preliminary results from those examinations and investigations were reported by Stephen Cutler, Director of the SEC's Division of Enforcement, in his testimony before this Committee in November, and the Commission has brought numerous enforcement actions and engaged in an aggressive rulemaking agenda as a result of the misconduct.

Prior to September 2004, however, examination staff did not detect the abusive market timing or late trading arrangements that fund executives had with select traders. We have been reviewing examination protocols to identify lessons learned from these cases and evaluating ways that our examination oversight can be improved, both to detect abusive market timing specifically, and more generally to timely detect other types of misconduct by fund firms.

My testimony today focuses on the changes we are making to our examination oversight, specifically with respect to market timing, and more broadly with respect to overall examination oversight generally. Our goal is to improve examiners' ability to identify and scrutinize transactions and arrangements that place the interests of fund shareholders at risk. Today, examiners are increasing the frequency and depth of examination reviews for high-risk firms; increasing the use of technology and data; developing new methods to identify new or emerging areas of compliance risk; conducting more targeted "mini-sweep" examinations to identify risk areas sooner; and working more closely with other staff at the Commission to highlight problems detected, and identify possible solutions sooner. Attached to this testimony is a comprehensive report on the Commission's examinations of investment companies and investment advisers prepared in response to the request made by Chairman Shelby to Chairman Donaldson on November 18, 2003. This report describes the examination program and these initiatives in greater detail, as well as recent enforcement actions brought by the Commission involving mutual funds.

Examination Steps to Better Detect Market Timing

Prior to the recent revelation of market timing and late trading abuses, examiners reviewed trading by a fund (for example, the fund's purchases and sales of securities on behalf of investors), but did not review trading in the fund's own shares. Examiners focused on whether funds were trying to inflate the returns of the fund, or take on undisclosed risk. The concern was that, in attempting to produce strong investment returns to attract and maintain shareholders, fund portfolio managers had an incentive to engage in misconduct in the management of the fund. As a result, examination protocols required that significant attention be focused on portfolio management, order execution, allocation of investment opportunities, pricing and calculation of net asset value, advertising returns, and safeguarding fund assets from theft. Examinations in these areas revealed problems and deficiencies. Because examiners' focus was on the fund itself, and not on trading in the fund's shares, however, examiners did not detect aberrant trading patterns that could be indicative of abusive market timing.

Although market timing in itself is not illegal, many mutual funds said that they discouraged the practice, and fund firms told examiners that the firms had appointed antimarket timing "police" who were responsible for detecting market timing trades and preventing timers from continued trading in their funds. The shocking development, not detected by examiners, was the secret complicity of some fund personnel in allowing select timers to continue to time.

Based on our recent examinations, we have identified ways to better detect market timing. These examinations have shown that daily sales and redemptions data can reveal patterns of trading in a fund's shares that may indicate market timing, and we now have made a review of this data a part of every routine examination. Additionally, our review of funds' books and records did not reveal the covert arrangements that fund executives had with select shareholders, allowing them to trade frequently in fund shares. These arrangements appear to have been evidenced often only in e-mail communications and not in written agreements, contracts, or other documents. In the past, routine examinations did not include a random review of employees' internal e-mail communications (unless there was cause to believe that particular communications were relevant to the examination). Now to aid in detecting any misconduct that might not otherwise be reflected in the books and records kept by the firm and shown to examiners, routine examinations include a review of a sample of fund executives' internal e-mail communications. We are now deploying software that will enable us to review large volumes of e-mail traffic, and we have made this a key element of our regular oversight.

Additional new examination steps include a review of personal trading records showing trading in the fund shares by select fund executives (even in advance of new Commission rules that would require that this information be made available), and a review of procedures to ensure that orders are processed to receive the appropriate day's net asset value, including firms' procedures governing order receipt time and order time-stamping.

Recent Commission rule proposals that would require better and more specific disclosure of funds' antimarket timing policies and a possible "Hard 4 p.m. Close" for receiving fund orders would aid examiners in detecting abuses of this type in the future. More broadly, the Commission has recently adopted rules to improve compliance by funds and advisers by requiring that they strengthen their own internal compliance programs. The new rules require that advisers and funds implement and maintain compliance policies and procedures designed to prevent, detect, and correct compliance problems in key areas of their operations. The new rules also require that funds and advisers designate a chief compliance officer to implement those compliance policies and procedures, and, in order to assist the fund board in exercising compliance oversight, to report on compliance matters to the fund's board of directors.

In sum, we are taking aggressive steps to address abusive timing, and to improve our ability to detect this type of misconduct.

Other Changes to Fund Examinations

We are implementing other changes to SEC examinations to enhance our ability to detect problems, as well as to anticipate problems before they become widespread. This is the central goal of the Commission's risk assessment initiative.

The challenge for any examination oversight program is to determine how best to use limited resources to oversee a large and diverse industry. More specifically, the challenge is to identify the areas of highest risk to investors, and to probe these areas effectively, while still providing examinations of each industry participant with appropriate frequency. In addition, once emerging trends and problems are identified, we must share our knowledge with other Divisions and Offices so that

the Commission can bring all of its resources to bear on efforts to protect investors. We have implemented or are implementing changes that we believe will better allow us to meet these challenges. These changes are summarized below.

New Fund Surveillance Program

As Chairman Donaldson announced on March 5, he has formed an SEC staff task force that will be drafting the outlines of a new surveillance program for mutual funds. This task force will examine the mutual fund reporting regime—looking at both the frequency of reporting to the Commission and the categories of information to be reported, as well as how new technologies can be used to enhance our oversight responsibilities. The goal of such a surveillance program would be to identify indications of problems, and then target the particular fund or adviser for follow up inquiry by telephone, letter, or on-site visit. Staff will also be able to examine the relevant data—industry-wide—to determine if a systemic problem is emerging.

Increased Use of Data Analysis

Examiners have been making increased use of computer technology to facilitate review of large volumes of data. This has significantly enhanced the level of oversight possible in critical areas such as portfolio trading and best execution.

Interviews

Examiners have been making increased use of interviews. More recently, these interviews have played a critical role when assessing a firm's control or risk environment.

More Frequent Examinations

With the additional resources added to the examination program in 2003, we are able to increase examination frequency of the largest fund firms, and those fund firms posing the greatest compliance risk (from once every 5 years, to once every 2 years). Prior to 1998, examination cycles had been as infrequent as once every 12–24 years.

More Targeted "Mini-Sweeps"

To quickly identify and investigate a particular industry practice, and to help the Commission and staff expeditiously solve or mitigate the compliance risk, we have been conducting more examination sweeps focused on particular issues. Examples of some of the ongoing or recent sweeps or mini-sweeps include: Payments by mutual funds for "shelf-space;" use of soft dollars by index funds, valuation and pricing of bond funds; fair value pricing; and practices of investment consultants.

Facilitating Immediate Corrective Action

Recently, we have adopted new policies to enhance the speedy resolution of any problems found, including holding exit interviews with senior management of firms and providing deficiency letters directly to fund boards of directors.

Requests for Reports

Examiners have increased their requests for written reporting by funds and advisers. This allows the staff to monitor compliance in between on-site examinations, obtain information on an expedited basis, and gather information on particular issues across a large number of firms. It also enables examiners to better manage and prioritize a large number of sweep examinations and focus examinations before the on-site portion of the review.

Collaboration with Other Commission Staff

As noted above, we must act promptly on emerging areas of compliance risk. To facilitate such action, examination staff must share exam findings and trends with other Commission staff. Now a committee composed of examination, enforcement, and regulatory staff reviews all examinations indicating serious problems to ensure that appropriate findings are investigated promptly. In addition, so that any emerging trends are identified and made known promptly, examination findings and trends are shared with other Commission staff on a routine basis. Examiners also seek input from other Commission staff on possible areas of examination scrutiny.

"Benchmarking" Examinations

We are adopting a program to test the assumptions we use in our routine, risk-based examinations. Each year, we will conduct comprehensive "wall-to-wall" examinations of a select number of firms to test the assumptions used in our risk-based exams and to benchmark our procedures. These comprehensive reviews should identify weaknesses in our risk-based models and allow us to expand, as needed, our review of risky activities.

Other Areas of Examination Scrutiny

As noted above, in addition to market timing, SEC's examiners are conducting sweep examinations and mini-sweep examinations designed to identify areas of emerging compliance risk. In routine examinations, examiners are also focusing on compliance risk areas. Examples of recent and current areas of scrutiny include: Allocations of securities among accounts; valuations of portfolio securities; use of soft dollars to pay for fund distribution; whether customers are provided with breakpoint and other discounts on purchases of funds; use of affiliated service providers; performance claims by advisers; antimoney laundering protections; Regulation S–P; and best execution, among other areas.

Conclusion

As outlined in this statement, and described in greater detail in the attached report, we are moving aggressively to implement the lessons learned from recent market timing abuses, and more broadly, to enhance our ability to detect abuses in the fund industry.

I would be happy to answer any questions you may have.

Thank you.

MEMORANDUM

TO: Chairman William H. Donaldson

FROM: Lori A. Richards
Office of Compliance Inspections and Examinations

DATE: March 10, 2004

RE: Request by Senator Richard C. Shelby, Chairman
U.S. Senate Committee on Banking, Housing and Urban Affairs

At the November 18, 2003 Senate Banking, Housing and Urban Affairs Committee hearing entitled "Review of Current Investigations and Regulatory Actions Regarding the Mutual Fund Industry," Chairman Richard C. Shelby requested that you provide him with a comprehensive report on the Securities and Exchange Commission's examinations of investment companies and investment advisers. At your request, the staff of the Office of Compliance Inspections and Examinations has prepared the attached report.

We recognize that the views expressed in this report may not necessarily reflect your views or those of the other Commissioners.

Attachment: As described

EXAMINATIONS OF INVESTMENT COMPANIES AND INVESTMENT ADVISERS March 2004

Executive Summary

This report describes examinations by the Securities and Exchange Commission ("SEC" or "Commission") of investment advisers and investment companies. It also describes the changes we are making to examinations generally, and with respect to detecting abusive market timing and late trading activity specifically. Examinations are a critical component in investor protection, and the SEC is taking steps to enhance its ability to detect abusive conduct in a timely manner.

The goals of examinations are to detect compliance problems and violations, and weaknesses in firms' internal control and compliance systems that could lead to violations of the federal securities laws.[1] When examiners identify a problem, they instruct the firm to make corrections, take any necessary remedial action, and improve their compliance in the affected area. Most often, these corrective actions involve improvements in internal controls and compliance practices to ensure that the problem is corrected and does not recur. When examiners identify serious problems, they also refer the matter to the SEC's enforcement staff for further investigation and possible enforcement action by the SEC.[2]

Currently, there are approximately 8,000 mutual funds, with $6.95 trillion in assets, managed by 900 investment company complexes. In addition, there are approximately 8,000 federally registered investment advisers, managing $20.1 trillion in assets (which includes the assets in mutual funds). The fund industry also involves a number of other service providers, including transfer agents, third-party administrators, and broker-dealers doing business with the public.

During most of the period 1998 to early 2003, the SEC's examination program for funds and advisers had approximately 370 members on its staff (including examiners, supervisors, and support staff). Routine examinations were conducted every five years. In 2003, program staffing was increased by one-third, to approximately 495 staff. With this staffing increase, the SEC will conduct more frequent examinations of funds and advisers posing the greatest compliance risks, and conduct more examinations targeted to areas of emerging compliance risk.

The SEC conducts three basic types of examinations: routine (conducted on a periodic basis); cause (conducted when there is reason to believe there is a problem at the firm); and sweep (special reviews focusing on a single issue). Examinations may be announced or unannounced;

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1 Funds and advisers are required to comply with the Investment Advisers Act of 1940 ("Advisers Act") and the Investment Company Act of 1940 ("Investment Company Act").

2 Attached to this report as an appendix is a list of recent enforcement actions brought by the Commission that involve funds and their advisers.

examinations for cause are typically conducted on a surprise basis. Examinations typically conclude with three possible outcomes: a deficiency letter, an enforcement referral, or a letter closing the examination without findings.

Given the number of firms subject to examination oversight and the breadth of their operations, examinations are not audits and are not comprehensive in scope; examiners must select discrete areas of firm operations to review. Examiners focus on areas that appear to pose the greatest risk to investors. New or emerging compliance issues may be addressed through special examination initiatives (including "mini-examination sweeps") or by being treated as priority items in routine examinations.

Prior to the recent revelation of market timing and late trading abuses, examination focus areas included trading by the fund (*i.e.*, the fund's purchases and sales of securities), but did not include a review of trading in the shares of the fund itself. Examiners' focus was on any trading in the fund that might be designed to inflate the returns of the fund inappropriately, or subject the fund to undisclosed risk. The concern was that fund portfolio managers were attempting to attract investors by producing strong returns, which could create an incentive for misconduct in the management of the fund. As a result, examination protocols required that significant attention be focused on portfolio management, order execution, allocation of investment opportunities, pricing and calculation of net asset value, marketing of returns, and safeguarding fund assets from theft. Because examiners' focus was on the fund itself, and not on trading in the fund's shares, examiners did not detect aberrant trading patterns that could be indicative of abusive market timing. Our recent examinations have shown that daily sales/redemptions data can reveal patterns of trading in a fund's shares that may indicate market timing, and we have now made a review of this data a part of every routine examination.[3]

Additionally, our review of funds' books and records did not reveal the covert arrangements that fund executives had with select shareholders allowing them to trade frequently in fund shares. These arrangements appear to have often been evidenced only in e-mail communications and not in written agreements, contracts, or other documents. In the past, routine examinations did not include a random review of employees' internal e-mail communications (unless there was cause to believe that particular communications were relevant to the examination). Now, to aid in detecting any misconduct that might not otherwise be reflected in the books and records kept by the firm and shown to examiners, routine examinations include a review of a sample of fund executives' internal e-mail communications. Additional new examination steps include a review of personal trading records showing trading in the fund shares by select fund executives (even in advance of Commission rules that would require that this information be made available), and a review of procedures to ensure that orders are processed to receive the appropriate day's net asset value.

Recent Commission rule proposals that would require better disclosure of funds' anti-market timing policies and a possible "hard 4 p.m." close for receiving fund orders will aid examiners in detecting abuses of this type in the future. More broadly, the Commission has recently adopted rules to improve compliance by funds and advisers by requiring that they strengthen their own

3 The staff is conducting numerous cause examinations specifically targeted to review for market timing and late trading.

internal compliance programs. The new rules require that advisers and funds implement and maintain compliance policies and procedures designed to prevent, detect, and correct compliance problems in key areas of their operations. The new rules also require that funds and advisers designate a chief compliance officer to implement those compliance policies and procedures, and, in order to assist the fund board in exercising compliance oversight, to report on compliance matters to the fund's board of directors.

Examination staff have been actively assessing other ways to enhance Commission examinations of funds and advisers, and are deploying other initiatives to improve examinations, including implementing a more formalized risk assessment function, increasing examination frequency for entities posing compliance risk, conducting more targeted examinations, and making greater use of technology, intelligence, and data.

Finally, examination staff will actively participate in the SEC's new risk assessment initiative. The Chairman has proposed the creation of an Office of Risk Assessment designed to better enable the Commission to anticipate, identify, and manage emerging risks and market trends that stand to threaten the Commission's ability to fulfill its mission. This initiative -- the first of its kind at the Commission -- will enable staff to analyze risks across divisional boundaries, focusing on early identification of new or resurgent forms of fraudulent, illegal or questionable behavior or products. This initiative seeks to ensure that senior management at the Commission have the information necessary to make better, more informed decisions. Additionally, by creating a risk assessment function, the agency should be better prepared to determine more quickly whether new business trends and industry practices warrant further attention by the SEC, and by its examiners, and to proactively adjust operations and resources to address these new challenges.

Each of these areas is described in greater detail in this report.

I. The Investment Management Industry

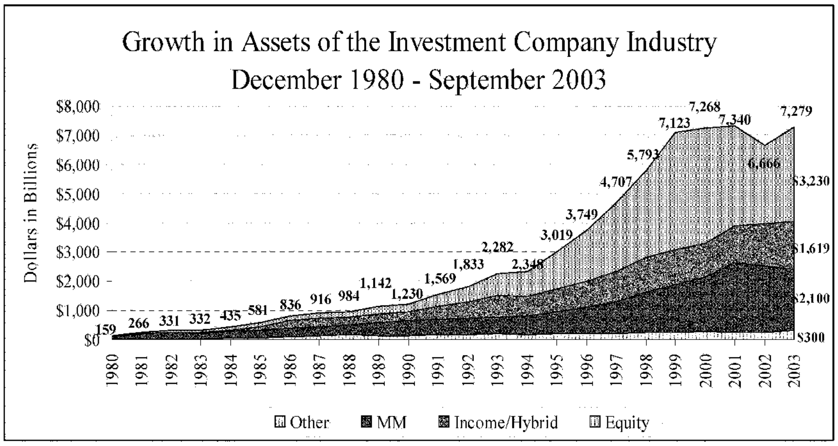
An investment company, managed by an investment adviser, invests shareholder capital in accordance with policies described in its prospectus. Open-end management investment companies, commonly known as "mutual funds," are the largest segment of the investment company industry. Currently, there are approximately 8,000 mutual fund portfolios, with approximately $6.95 trillion in assets under management. Approximately 900 investment company complexes manage these portfolios. In addition to mutual funds, the investment company industry contains several thousand other portfolios, such as exchange-traded funds, closed-end funds, unit investment trusts, and variable products – both variable annuities and variable life insurance.

Investment advisers engage in the business of advising others as to the value of securities or as to the advisability of investing, purchasing, or selling securities. With certain exceptions, only investment advisers with $25 million or more in assets under management may register with the Commission. Approximately 8,000 investment advisers have registered with the Commission. They manage approximately $20.1 trillion in assets, which includes the $6.95 trillion in mutual fund portfolios.

There are a wide variety of investment management portfolios. Investment company portfolios include money market funds, equity funds, bond funds, and hybrid funds combining features of the others. Money market funds include portfolios specializing in taxable money market instruments and tax-free instruments. Equity or stock funds include portfolios offering growth, growth and income, international equities, and equities from specific industry sectors or indexes. Bond funds include portfolios specializing in government bonds, corporate bonds, global bonds, and municipal bonds.

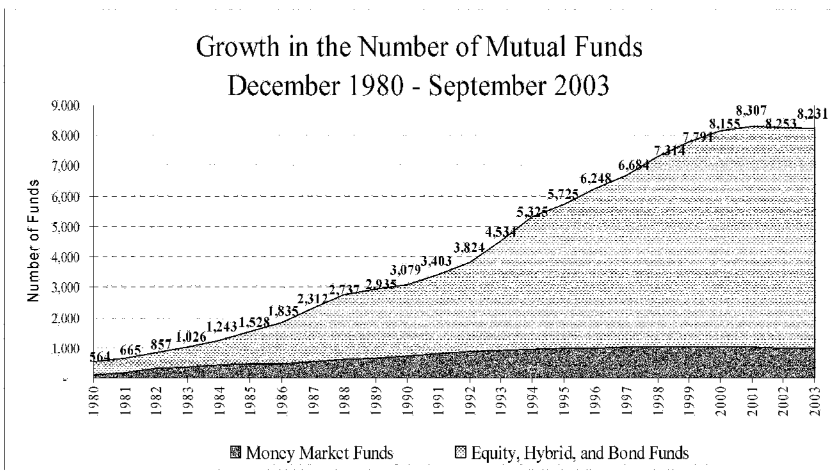
In addition to investment companies and fund portfolios, operation of the fund industry involves a number of other types of entities providing a variety of services. These include transfer agents that process fund shareholders' transactions, third-party administrators that provide back office functions, and approximately 6,800 broker-dealers, many of which sell mutual fund shares to the public or execute transactions for fund portfolios.

As shown in the charts below, the investment management industry has grown over the last 23 years, both in terms of assets under management and the number of funds. In particular, during the 1990s, a strong stock market, a robust American economy, and increased use of defined contribution plans provided a favorable environment for its growth.



Note: Other investment companies include: unit investment trusts, closed-end funds and exchange traded funds.
Source: Statistics compiled using various sources of information.

The number of mutual funds has also increased, as shown by the chart below.



Source: Statistics provided by the Investment Company Institute.

The size, diversity, and growth of the fund industry pose significant regulatory challenges. Indeed, in 1997, the United States General Accounting Office issued a report entitled *Mutual Funds: SEC Adjusted its Oversight in Response to Rapid Industry Growth*.[4] The GAO found that growth in the fund industry had posed a significant challenge to the SEC, met by increasing examination staff, refocusing the scope of its examination reviews, and targeting routine examinations to a minimum of one examination every five years. Since 1997, the fund industry continued to grow, from \$4.6 trillion to \$7.3 trillion in assets under management.[5]

The size and importance of the investment management industry make it a critical focus of the Commission's regulatory oversight. The SEC regulates funds through a multi-faceted program. Working under the direction of the Commission, several offices within the SEC integrate their functional expertise to review fund disclosure, adopt rules governing disclosure and other fund and adviser activities, examine funds and advisers for compliance, serve investors who complain to the SEC about funds and securities professionals,[6] and bring enforcement actions against fund complexes and responsible individuals that have violated the securities laws. This report focuses on examinations of funds and advisers.

II. Recent and Current Initiatives to Enhance Examination Oversight

Examinations are a critical component of investor protection. The SEC has continuously worked to upgrade and enhance its program for examining mutual funds – with the goal of improving examiners' ability to identify and scrutinize transactions and arrangements that place the interests of fund shareholders at risk. Today, examiners are increasing the frequency and depth of examination reviews for high risk firms, better using technology and data in examinations, giving examiners discretion to identify new or emerging areas of compliance risk, conducting more targeted "mini-sweep" examinations to identify risk areas sooner, and working closely with other staff at the Commission to highlight problems detected, and identify possible solutions sooner, among other things. New or recently implemented initiatives and changes to examinations are described below.

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4 United States General Accounting Office, *Mutual Funds: SEC Adjusted its Oversight in Response to Rapid Industry Growth*, GAO/GGD-97-67 (May 1997).

5 From 1997 through 2003, the total assets under management by investment advisers, including funds, increased by 54.6%, from \$13 trillion to \$20.1 trillion. From 1997 through early 2003, staffing for inspections remained relatively constant, at between 360 and 380 positions.

6 During fiscal year 2003, the Commission received more than 200,000 letters, e-mails, and phone calls from investors. The Commission's staff is considering ways to ensure that tips and complaints indicating violations are handled appropriately.

A. Frequency of Examinations

1. The Five-Year Cycle (1998 to 2003)

From 1998 until early 2003, the SEC conducted routine examinations of mutual funds and advisers on a five-year cycle (prior to 1998, examinations had been much less frequent).[7] In other words, some aspect of every investment company complex and every federally registered adviser would be examined at least once every five years.[8]

2. Formal Risk Assessment (2003)

While the examination program met the five-year goal, the staff was concerned that the five-year cycle was a relatively unsophisticated methodology. Funds and advisers with high-risk business models, poor risk management systems or poor internal controls require more frequent oversight.

During 2003, the examination program improved its process for assessing risk and incorporating that risk assessment into determinations of examination frequency and scope. Specifically, examination methodology was implemented to provide a more formal assessment of firms' internal compliance and control processes by use of a risk evaluation methodology designed to guide examiners in their evaluation of firms' risk assessment, mitigation, and management processes. The methodology requires examiners to evaluate the effectiveness of the firm's controls in each of several key risk areas,[9] and to assess the overall risk and compliance culture of the firm.

The risk assessments prepared through this methodology assist examiners in scheduling the next examination of the fund or adviser. Firms carrying the highest risk will be inspected most often. Thus, this new methodology seeks to predict the likely risk profile of the fund or adviser in the future by identifying those firms that have weak compliance controls, as well as by using other factors. This more formal risk assessment will lead to the new inspection frequency described below.

3. New Inspection Frequency

With the additional staff resources added to the program in late 2003 (discussed later in this report) and the new formal risk profiles, the examination program is moving to a more

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[7] Prior to the adoption of the National Securities Markets Improvement Act in 1996, which allocated regulatory responsibility for smaller advisers to state securities regulators, the examination cycle for advisers had been as infrequent as once every 12 to 24 years.

[8] This goal was incorporated into the Commission's Government Performance and Results Act Performance Plan as an annual performance goal for the overall mission goal of protecting investors, and included in the agency's public *Annual Performance Reports.*

[9] The strategic risk areas covered in these evaluations are: portfolio management, brokerage arrangements and best execution, trade allocations, personal trading, pricing and calculation of net asset value, information resources, safety of client and fund assets, marketing and distribution, fund shareholder transactions, anti-money laundering, and fund corporate governance (a discussion of each area and the areas that the staff probes during examinations is included later in this report).

sophisticated system for scheduling examinations. Instead of examining every fund or adviser at least once every five years, firms will be selected for review on a two-, four-, or five-year cycle. Specifically:

- The largest fund groups (top 20), and funds and advisers presenting a high risk profile will be examined every two years;
- All other fund groups (including their advisers) will be examined every four years; and
- All other advisers (not high risk, not part of a fund group) will be examined every four to five years.

Commission staff is also continuing to evaluate the appropriate frequency of examinations, including more frequent reviews for the highest risk firms, and more "mini-examination sweeps" focused on emerging areas of compliance risk.

In addition, the examination program will participate in an agency-wide formal risk-assessment program designed to identify risks, integrate them across program areas, and then elevate them for management deliberation and appropriate action. We anticipate that this program will aid the agency in identifying and responding to compliance risk areas in a more focused way.

B. Enhancements to the Examination Process

1. New Examination Procedures to Address Market Timing and Late Trading (2003)

Market timing: As noted, our examination protocol in the past did not include a review of trading in the fund's own shares, and examiners did not obtain trading data that would show patterns of trading indicative of market timing. Now, examinations include a request for the fund to prepare and produce to the staff a daily summary of net sales and redemptions for a select period of time.[10] This data will allow the staff to review trading in the fund's shares for indications of aberrant trading, such as abusive market timing. In addition, routine examinations also now include a request for a sample of internal employee e-mail communications, which examination staff will review for indications of wrongful conduct that may not be reflected in the firm's other books and records. Additionally, while current SEC rules do not require fund employees to report to the fund their personal trades in the fund's own shares, in order to review for possible abusive trading by fund insiders, examiners now request that select fund executives produce to examiners their personal securities trading records.[11]

[10] In adopting the compliance rule on December 17, 2003, the Commission stated that "a fund must have procedures reasonably designed to ensure compliance with its disclosed policies regarding market timing. These procedures should provide for monitoring of shareholder trades or flows of money in and out of the funds in order to detect market timing activity." *See infra* n.34 and accompanying text. Thus, examiners will expect that funds will create, maintain, and provide records of daily fund transactions to examiners.

[11] The staff is actively examining and participating in enforcement investigations of dozens of fund firms related to possible abusive market timing. Preliminary results from these reviews were reported publicly in testimony by Stephen Cutler in hearings concerning recent Commission activity to combat misconduct relating to

Late trading: Our experience is that omnibus order processing and the creation of false order tickets can make detecting instances of late trading difficult.[12] We are conducting numerous examinations to review for late trading. To aid in this review, in October, the examination staff sent letters to the approximately 300 firms that use the National Securities Clearing Corporation's Fund/SERV system[13] to transmit orders electronically after 4:00 p.m. to fund transfer agents, requesting that these firms[14] voluntarily conduct a review of their policies and procedures to prevent late trading, to identify any instances of late trading, and to report the results to the Commission staff. Preliminary findings indicate that none of the responding firms admit that their systems and controls were inadequate to prevent late trading, though many state that they have made recent changes to enhance their ability to prevent late trades. Approximately half of the responding firms either provided incomplete responses or described situations that may constitute late trading. However, most of those firms describing possible late trades attributed them to human error, system error, or the correction of errors in orders. Examinations of many of these SEC-registered firms will be conducted, and findings with respect to non-registered firms will be brought to the attention of banking and other regulators.

In routine examinations, SEC, NASD and NYSE examiners will review firms' procedures governing order receipt time, order time stamping, and supervisory oversight of fund trade processing.

2. New Examination Procedures to Enhance the Overall Program (1998 to 2004)

Increased use of data analysis: Examiners have been making increased use of computer technology to facilitate review of large volumes of data. This has significantly enhanced the level of oversight possible in critical areas such as portfolio trading and best execution. Examiners are continuing to explore other ways to utilize technological tools to surveil for possible violations, and to identify new sources of information and data that may alert staff to emerging compliance risks and highlight the need for on-site or other review by the staff.

Interviews: Examiners have been making increased use of interviews. Over the years, examiners have frequently sought to interview firm employees. Questions could include specific

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mutual funds by the Senate Subcommittee on Financial Management, the Budget, and International Security, Committee on Governmental Affairs (Nov. 3, 2003), and by the Senate Committee on Banking, Housing and Urban Affairs (Nov. 20, 2003).

12 In light of this, the Commission has proposed a "hard 4 p.m." order cutoff time for receipt by the fund or its agent of customers orders to receive that day's net asset value, as well as other alternatives to prevent late trading. *See SEC, Amendments to Rules Governing Pricing of Mutual Fund Shares,* Investment Company Act Release No. 26288 (Dec. 11, 2003); *see also* 68 Fed. Reg. 70388 (Dec. 17, 2003).

13 Fund/SERV provides a central processing system that collects order information from clearing brokers and others, sorts all the incoming order information according to the fund, and transmits the order information to each fund's primary transfer agent.

14 These firms include broker-dealers, banks, insurance companies, and pension administrators.

inquiries about the firm's record keeping or accounting practices, or the meaning of specific records. More recently, however, interviews have played a critical role when assessing a firm's control or risk environment.[15]

Policies to facilitate immediate corrective action: Recently, new policies have been adopted to enhance the speedy resolution of any problems examiners found, including by holding exit interviews with senior management of firms (often done by telephone) and providing deficiency letters directly to fund boards of directors.

Requests for reports: Examiners have been making increased use of requests for written reporting by funds and advisers. When this approach is taken, examiners write the firm asking it to provide written answers to the staff's questions and to provide copies of documents substantiating the statements. This allows the staff to monitor compliance in between on-site examinations, obtain information on an expedited basis, and gather information on particular issues across a large number of firms. It also enables examiners to better manage and prioritize a large number of sweep examinations and focus examinations before the on-site portion of the review.

Review of examination findings: All examinations indicating serious problems are reviewed by a committee of staff (comprised of examination, enforcement, and regulatory staff) to ensure that appropriate findings are investigated promptly. In addition, so that any emerging trends are identified and made known promptly, examination findings and trends are shared with other Commission staff on a routine basis.

III. The Commission's Examination Authority

The SEC is authorized to examine the records of investment companies,[16] investment advisers,[17] transfer agents, [18] broker-dealers,[19] and other types of regulated securities firms.[20] By law, the Commission's examinations may be "periodic," "special," or "other,"[21] which, as the relevant statutes explicitly indicate, means that they may be conducted "at any time, or from time to

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15 As described later in this report, while many firms agree to voluntary interviews, the authority of the examination staff in this area is unclear.

16 Investment Company Act § 31(b), 15 U.S.C. § 80a-30(b).

17 Advisers Act § 204, 15 U.S.C. § 80b-4.

18 Securities Exchange Act of 1934 (hereinafter cited as "Exchange Act") § 17(b), 15 U.S.C. § 78q(b).

19 *Id.*

20 *See id.* (authorizing SEC to examine national securities exchanges, registered securities associations, registered municipal securities dealers, and registered clearing agencies, among others).

21 Exchange Act § 17(b), 15 U.S.C. § 78q(b); Advisers Act § 204, 15 U.S.C. § 80b-4; Investment Company Act § 31(b), 15 U.S.C. § 80a-30(b).

time."[22] The SEC may perform such "reasonable" examinations as "it deems necessary or appropriate in the public interest for the protection of investors."[23]

The legislative history of the SEC's examination authority demonstrates that examinations are expected to play an important role in the Commission's efforts to enforce the securities laws. An important goal of SEC examinations is to find violations, particularly on-going violations. In 1934, the Senate Committee on Banking and Currency stated that the Commission's authority to conduct reasonable inspections of brokers' records would enable it "to obtain evidence rapidly" when a violation appeared to be in progress.[24]

Congress recognized that examinations have other functions as well. In 1960, in the course of amending the securities laws to give the Commission examination authority over investment advisers,[25] the Senate Committee on Banking and Currency stated that the "prospect of an unannounced visit of a Government inspector is an effective stimulus for honesty and bookkeeping veracity."[26] Thus, beyond finding violations, SEC examinations also serve a prophylactic role.

In 1975, the SEC was given authority to examine "all" records of investment advisers, broker-dealers, transfer agents, national securities exchanges, and securities associations.[27] In describing the amendments, the Committee said that the language of the section conferring examination authority over entities registered under the Exchange Act:

> Makes clear that it is self-executing, *i.e.*, there would be no need for the Commission, as a condition precedent to inspecting any reports, to require by rule that the persons described in [the section] keep any such records. Moreover, the authority to examine records would include the authority to make or require copies of such records."[28]

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22 *Id.*

23 Exchange Act § 17(b), 15 U.S.C. § 78q(b); Advisers Act § 204, 15 U.S.C. § 80b-4.

24 S. Rep. No. 792, 73d Cong. 2d Sess. 13 (1934) (discussing rapid response to indications of manipulation); *reprinted in* 1 Federal Securities Laws, Legislative History, 1933-1982, 708, 720 (BNA eds.) (1983).

25 Advisers Act Amendments of 1960, Pub. L. 86-750, § 6, § 204, 74 Stat. 885, 886 (1960), *codified at* 15 U.S.C. § 80b-4.

26 S. Rep. No. 1760, 86th Cong., 2d Sess. (1960), *reprinted in* 1960 U.S.C.C.A.N. 3502, 3505.

27 S. Rep. No. 94-75, at 119-20, *reprinted in* 1975 U.S.C.C.A.N. 179, 297. While this statement addressed the agency's responsibilities under the Exchange Act, as set forth below, identical amendments were simultaneously made to the Commission's examination authority under the Advisers Act.

28 *Id.* At the same time, the same language was added to the Advisers Act. Securities Acts Amendments of 1975, Pub. L. 94-29, sec. 29(5), *amending* Advisers Act § 204, *codified at* 15 U.S.C. 80b-4; 89 Stat. 97, 138 & 169 (1975).

With respect to mutual funds, the Commission's examination authority is limited to the records that investment companies are required to maintain and preserve.[29] Efforts by the Commission to examine fund records beyond those required to be maintained and preserved must be done on a voluntary basis.[30]

SEC examiners seek to engage firms in a dialogue through interviews, exit conferences, and requests for voluntary preparation of data or analyses that are not specifically required to be maintained. In many instances, firms are willing to engage in this type of voluntary communication and cooperation in providing records and information. Such communications are often subject to negotiation, requests for non-waiver agreements, and other restrictions. Aside from providing their books and records for examination, registrants have no legal obligation to volunteer information about the existence of violations or compliance problems to examiners.[31]

Unlike broker-dealers, investment advisers and mutual funds are not subject to self-regulation and are regulated and examined solely by the Commission.[32] However, like broker-dealers, advisers are potentially liable if they fail to reasonably supervise.[33] Moreover, to improve compliance within funds and advisers, in December, 2003, the Commission adopted a new rule requiring that all funds and advisers implement and maintain written compliance policies and procedures reasonably designed to prevent violations from occurring, detect violations that have occurred, and correct promptly any violations that have occurred. Each fund and adviser must review those policies and procedures annually for their adequacy and the effectiveness of their implementation. The new rule further requires that all funds and advisers designate a chief compliance officer to be responsible for administering the policies and procedures and to report annually to the fund's board concerning material compliance matters.[34] This rule is designed to protect investors by ensuring that all funds and advisers have internal programs to ensure compliance with the federal securities laws, and to ensure that fund boards of directors have adequate information to fulfill their obligation to exercise compliance oversight.

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[29] Investment Company Act § 31(b), 15 U.S.C. § 80a-30(b).

[30] In the mid-1990s, during the 104th Congress's consideration of the National Securities Markets Improvement Act, the Commission proposed an amendment to the Investment Company Act that would have extended its "all records" examination authority to funds.

[31] There are criminal penalties for lying to a federal government official or concealing material facts in any matter within the jurisdiction of any agency of the federal government. *See* 18 U.S.C. § 1001.

[32] Broker-dealers are subject to self-regulation, which includes routine examinations by the NYSE, NASD, or one of the options self-regulatory organizations. The NYSE examines each of its members that do business with the public every year, and the NASD regularly examines it members according to a schedule based on the member's risk profile.

[33] Investment Advisers Act §203(e)(6), *codified at* 15 U.S.C. §80b-3(e)(6).

[34] *See SEC, Compliance Programs of Investment Companies and Investment Advisers*, Investment Advisers Act Release No. 2204, Investment Company Act Release No. 26299 (Dec. 17, 2003); *see also* 68 Fed. Reg. 74714 (Dec. 24, 2003).

IV. Examinations of Advisers and Funds

A. Program Staff

The Office of Compliance Inspections and Examinations ("OCIE") provides program management for examinations. Examinations are conducted by staff in OCIE and in the SEC's 11 regional and district offices.[35] From 1998 through early 2003, staffing for examinations of funds and advisers ranged from 360 to 380 positions (including supervisors, examiners, and support staff).[36]

With a budget increase in 2003, staffing for fund and adviser examinations increased by 33%, to 495 positions.[37] In addition, pay comparability legislation allowed the Commission to increase salaries for its staff.[38] This authority has helped reduce substantially the staff attrition and turnover rates previously faced by the SEC.[39]

Examiners have a variety of educational degrees and experience, including, masters of business administration, certified financial analysts, certified public accountants, lawyers, and computer specialists. Most recently hired examiners have had experience in the securities industry and/or specialized training. Examiners are trained in entry-level, mid-level, senior, and specialized training programs. A training branch in OCIE coordinates training for the examination program nation-wide.

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35 Regional and district offices of the SEC are located in New York, Boston, Philadelphia, Miami, Atlanta, Chicago, Denver, Fort Worth, Salt Lake City, San Francisco, and Los Angeles.

36 In 1998, there were 360 staff positions dedicated to adviser/fund examinations; in 1999 and 2000, there were 380 positions; in 2001 and 2002, there were 366 positions. These numbers include supervisory, staff, and clerical positions dedicated to adviser/fund examinations and exclude staffing for general and administrative office support. By way of comparison, federal regulators responsible for supervising banking organizations deploy significantly more examination staff relative to the number of organizations they regulate, reflecting the differences between the supervisory model of oversight applied to banks and the risk-based examination model applied to securities firms. The Federal Reserve has approximately 1,235 field examiners (FRB's 2002 Annual Report), and the Office of the Comptroller of the Currency has approximately 1,800 examiners (Wall Street Journal 1/8/04).

37 The Commission's $716 million fiscal 2003 appropriation pursuant to P.L. 108-7 permitted the SEC to begin hiring over 840 new employees, primarily spread amongst the agency's examination, full disclosure, and enforcement programs.

38 The Investor and Capital Markets Fee Relief Act (P.L. 107-123) exempted the SEC from the pay and benefit provisions of Title V of the U.S. Code and allowed the Commission to compensate staff at levels comparable to those provided by the federal government's other financial regulatory agencies.

39 About one-third of the SEC staff left the agency from 1998 through 2000 and the average tenure of an examiner declined from 2.9 years in 1992 to 1.9 years in 1999. *See United States General Accounting Office, "Securities and Exchange Commission: Human Capital Challenges Require Management Attention,"* GAO-01-947 (September 17, 2001).

B. Types of Examinations

The SEC conducts several types of examinations, described below.

Routine Examinations: Routine examinations are scheduled based on the passage of time since a firm has been examined. These examinations are focused in scope (*i.e.*, they are not comprehensive). They may focus on areas that have been identified as posing the greatest compliance risk generally, as well as areas that may pose compliance risk for the particular firm being examined.

Cause Examinations: Cause examinations are based on indications, allegations, or tips regarding wrongdoing or inappropriate conduct at the firm.[40] The goal of a cause examination is to quickly determine whether there is a problem. These examinations are typically unannounced and conducted on a "surprise" basis.

Sweep Examinations: Sweep or "theme" examinations focus on a narrow issue and seek to determine how a sample of the industry is handling that particular issue. Sample sizes can range from hundreds of firms to less than ten, depending on the issue. The goal of a sweep examination is to gather information in a systematic fashion across the industry.

During the period 1998 to 2003, examinations of each type were performed, as follows:[41]

Investment Companies:		**Investment Advisers:**	
1304	Routine Examinations (85%)	8117	Routine Examinations (92%)
155	Cause Examinations (10%)	549	Cause Examinations (6%)
67	Sweep Examinations (4%)	116	Sweep Examinations (1%)

C. Outcomes

Examinations can result in three primary outcomes. These are described below.

Deficiency Letter: A deficiency letter is a summary of examination findings and can include violations of the law as well as supervisory and control weaknesses. Deficiency letters are provided to the firm at the conclusion of the examination and require it to respond within 30 days, documenting the steps it intends to take to correct the deficiencies. Deficiency letters most often result in correction of the problem, and implementation of improvements in compliance policies and procedures to prevent the problem from reoccurring.[42]

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[40] Cause examinations may be initiated as a result of a complaint from an investor or a press article, based on information obtained from the review of disclosure documents or other filings, or from other sources.

[41] Percentages do not total 100% due to rounding. These numbers understate the actual number of sweep exams as sweep exams are often conducted in tandem with a routine exam, and the exam is classified as primarily routine.

[42] Examples of these remedial actions are described below.

Enforcement Referral: When examiners find a violation of the securities laws, they must determine whether it should be referred to the Division of Enforcement staff for further investigation and possible enforcement action. The decision whether a violation is suitable for referral involves judgment and is made on a case-by-case basis in consultation with Enforcement staff. Violations involving fraud, abuse of customers, intentional wrongdoing, or significant investor losses are generally referred for enforcement investigation and possible action.[43]

Letter Closing the Examination: Where the staff makes no findings, at the conclusion of the examination it gives the firm a letter indicating that the examination has concluded without findings.

During this period, examinations concluded with the following primary outcomes:

Investment Companies		**Investment Advisers**	
1303	Deficiency Letters (85%)	7931	Deficiency Letters (90%)
88	Enforcement Referrals (6%)	316	Enforcement Referrals (4%)
135	Closed Without Findings (9%)	535	Closed Without Findings (6%)

D. Scope of Examinations

As noted, given the number of registrants and the range and breadth of their activities, examinations do not review all areas of the law or all business activities of the firm or fund complex. Examiners select areas to review with the goal of focusing their efforts on those activities that are most at risk, from an investor protection view, of harboring significant compliance problems. This process for narrowing and focusing the scope of inspections on higher risk activities is called conducting "risk-based" examinations.

Activities that are not subject to robust internal compliance controls are more likely to be at risk of violations and compliance problems. Thus, to evaluate areas of a firm's activities that may be at risk, examiners begin with an assessment of the firm's internal controls and compliance policies and procedures. Examiners assess the breadth and apparent effectiveness of firms' control processes and then conduct further detailed testing of underlying transactional information in those areas where compliance and control processes appear to be weak or lacking altogether. Regardless of how effective a firm's controls may be, examiners always scrutinize certain fundamentally important information as an overall or forensic check on the efficacy of controls.

E. Areas of Review

Summarized below are major areas that may be reviewed during fund and adviser examinations. It is important to note, however, that examiners may focus on these areas, or any area where they have reason to believe there are compliance risks. In each area where examiners identify problems, examinations typically result in corrective actions being taken by firms. Most frequently, these actions include improvements in internal compliance policies and procedures

43 A list of recent SEC enforcement actions involving funds is attached as Appendix A.

designed to correct the problem and ensure against its reoccurrence. As described herein, some findings also result in enforcement actions.

Portfolio management: Examiners consider whether the securities recommendations and investments made for clients and funds are consistent with each client's investment objectives, restrictions, and risk tolerance. The following areas are among those probed during inspections:

- What are the conflicts of interest an adviser confronts in managing clients' investments; how can clients be harmed by these conflicts; and how does the adviser disclose, mitigate and manage these conflicts?
- Are the firm's policies, procedures, and controls effective in light of the portfolio management environment maintained by the firm?
- Are investments suitable for clients and consistent with their objectives, restrictions, and risk tolerance?
- Is leverage consistent with statutory limitations?
- Is non-public information that may be obtained during research on issuers handled consistently with the firm's insider trading prevention policies?
- Are proxies voted in ways that reflect the best interests of clients who own the securities?
- Are decisions to purchase securities in an underwriting in which a fund affiliate is a participant consistent with the law?
- Are investment advisory fees being calculated in ways that are consistent with clients' advisory contracts?
- Does a review of purchases and sales of securities around the end of the reporting period indicate the presence of window-dressing or manipulative trading?

Brokerage arrangements and best execution: Examiners consider whether brokerage arrangements are consistent with disclosures, whether the adviser seeks best execution in placing all trades for clients, and whether the adviser periodically and systematically evaluates the costs and benefits of its brokerage arrangements. The following areas are among those probed during inspections:

- What are the conflicts of interest an adviser and its trading desk staff confront in placing orders and causing clients to pay brokerage commissions; how can clients be harmed by these conflicts; and how does the adviser disclose, mitigate, and manage these conflicts?
- Are the firm's policies, procedures, and controls effective in light of the brokerage arrangements maintained by the firm?
- Does the firm regularly seek to obtain best execution when placing orders for clients' accounts?
- Does the firm periodically and systematically evaluate the quality and cost of its brokerage arrangements to determine if it is obtaining best execution?
- What does the firm obtain with commission dollars, including research within the safe harbor? Is a fund using its brokerage commissions to pay for distribution of its shares outside of a distribution plan ("Rule 12b-1" plan)? Is the adviser using brokerage to pay for client referrals?

- Are research services obtained with soft dollars consistent with disclosures made to advisory clients?
- Are cross trades among funds consistent with the requirements of the law?
- Does a fund's adviser use forensic analysis of period data to determine if the cross trades implemented during the period were fair to all participating funds?
- Is the firm's process for overseeing the clearance and settlement of its trades effective?

Allocations of trades: Examiners consider whether the adviser has effective policies and procedures for fairly allocating initial public offerings ("IPOs") and block trades among clients, whether these policies are adequately disclosed, and whether actual practices are consistent with both policies and disclosures. The following areas are among those probed during inspections:

- What are the conflicts of interest an adviser and its portfolio managers/traders confront in allocating investment opportunities among clients; how can clients be harmed by these conflicts; and how does the adviser disclose, mitigate, and manage these conflicts?
- Does the adviser/fund have policies and procedures that are likely to result in fair allocations of block and IPO trades among its clients and are those policies and procedures fully disclosed?
- Are the trade allocation procedures actually used consistent with the policies, procedures, and disclosures?
- Are there indications of preferential allocations among accounts (*e.g.*, to favored accounts such as those paying higher fees)?
- Does the adviser use forensic analysis of period data to ensure that the results of its allocations during the period were consistent with its disclosures?
- Does the adviser ensure that all trades are allocated in ways originally intended by portfolio managers and that if changes to allocations are made, there is an effective audit trail that prevents cherry picking?
- Does an adviser that manages hedge funds and other fund clients have controls to ensure that allocations are fair among all clients and consistent with disclosures?

Personal trading: Examiners consider whether funds and advisers have effective codes of ethics that are designed to prevent inappropriate trading in equities by insiders in their personal accounts, whether these policies are fairly disclosed, and whether actual trading practices by insiders comport with the policies and disclosures. The following areas are among those probed during inspections:

- What are the conflicts of interest an adviser and its staff confront in making investment decisions for their personal accounts; how can clients be harmed by these conflicts; and how does the adviser disclose, mitigate, and manage these conflicts?
- Does the adviser/fund have a code of ethics that includes appropriate controls over and reporting of personal trades in equities by insiders?
- Has the adviser disclosed its personal trading policies to clients and fund boards?
- Are insiders reporting their personal trades in equities on a timely basis? Is the adviser reviewing them on a timely basis and comparing trading of access persons to

trading for clients to determine if there has been front-running or other abusive trading by insiders?
- Are trades of insiders consistent with the code of ethics? Are there indications of front-running, insider trading, or other abusive activity?
- Are there indications of abusive trading fund insiders in the fund's own shares?
- What sanctions have been imposed on insiders who violate the code of ethics?

Pricing of clients' portfolios and calculation of net asset value: Examiners consider whether funds and advisers have effective policies and procedures for determining the value of portfolio holdings and calculating net asset value, whether fund boards of directors have established adequate procedures to calculate fair values when market prices are not available, and whether actual practices are consistent with these policies and procedures. The following areas are among those probed during inspections:

- What are the conflicts of interest an adviser and its staff confront in valuing assets in clients' portfolios and calculating fund net asset values; how can clients be harmed by these conflicts; and how does the adviser disclose, mitigate, and manage these conflicts?
- Does an adviser/fund have effective policies, procedures, and controls with respect to the pricing of portfolio securities and calculating the fund's net asset value per share?
- Has the fund's board of directors established a pricing policy and approved procedures for the use of fair value pricing?
- If the board has established a policy, is it being implemented?
- Does daily sales and redemption activity indicate possible market timing?
- Does the fund monitor for events that may make its market-price based net asset value stale and use fair value pricing in these circumstances to ensure an accurate net asset value?
- Is the process used to identify corporate events such as dividends and stock splits effective?
- Does the fund monitor prices used for individual securities to make sure they fully reflect the value of the security at the time net asset value is being calculated?
- Does the fund monitor changes in its net asset value from day to day to make sure such changes reflect activity in the market place?
- Does the fund check the accuracy of its fair value process by comparing selling prices for securities that were fair-valued to the previous day's fair value?

Information processing and protection (books and records, disclosures, and filings): Examiners consider whether funds and advisers have effective policies and procedures for capturing, compiling, maintaining, and reporting relevant and timely information to clients and regulators, and whether such information is effectively protected from access by unauthorized persons and untimely destruction. The following areas are among those probed during inspections:

- What are the conflicts of interest an adviser and its staff confront in compiling, maintaining, using, and reporting information; how can clients be harmed by these conflicts; and how does the adviser disclose, mitigate, and manage these conflicts?

- Are the adviser's/fund's books and records current and contain all of the information required by the recordkeeping rules?
- Are books and records maintained in ways that protect the information in them from unauthorized access and alteration and from unplanned destruction?
- Are books and records being maintained for prescribed periods?
- Is the personal information of clients/shareholders protected from inappropriate uses and disclosures?
- Does the firm protect the personal information of its clients/shareholders from identify theft?
- Are filings with regulators made on time and contain all necessary information?

Performance advertising, marketing, and fund distribution activities: Examiners consider whether funds and advisers have effective policies and procedures to make sure performance claims, advertisements, and other marketing materials contain only appropriate information and whether conflicts of interest have been effectively disclosed. The following areas are among those probed during inspections:

- What are the conflicts of interest an adviser, fund, principal underwriter, or their staffs confront in marketing the firm's services, using performance advertising and distributing fund shares; how can clients/fund shareholders be harmed by these conflicts; and how does the adviser/fund disclose, mitigate, and manage these conflicts?
- Does the adviser/fund have effective policies, procedures, and controls that cover all of its advertising, marketing, and distribution activities?
- Are advertisements accurate, complete, and not misleading?
- Is all performance information used in advertisements and other presentations calculated appropriately and is it accompanied with all necessary information to make it not misleading?
- Is the use of solicitors consistent with regulations?
- Are client referral arrangements and related directed brokerage arrangements consistent with disclosures made to referred clients?
- Has the fund's Rule 12b-1 plan been approved annually by its board and is the operation of the plan consistent with the rule?

Safety of clients' and funds' assets: Examiners consider whether funds and advisers have effective policies and procedures for safeguarding their assets from loss, misappropriation, and misuse. The following areas are among those probed during inspections:

- What are the conflicts of interest an adviser and its staff confront in making sure clients' assets are safeguarded from misuse and loss; how can clients be harmed by these conflicts; and how does the adviser disclose, mitigate, and manage these conflicts?
- Does the adviser/fund have effective policies, procedures, and controls regarding the custody and safekeeping of assets?

- Has the fund provided its custodian with a current list of authorized persons who can authorize movement of a fund's assets?
- Do authorizations to move fund assets require signatures of at least two persons?
- Are there adequate controls over the creation and use of such authorizations?
- Are the fund's custody arrangements for its foreign securities consistent with SEC rules?
- Does the custodian of advisory clients' assets send periodic statements directly to such clients? Does the adviser alone report to clients?
- If an adviser has self-custody of a client's assets, is it regularly audited by an independent auditor, on a surprise basis?
- Is there a process for regularly reconciling client and fund balances of securities owned with those shown by custodians? Do the books reconcile?

Fund shareholder order processing: Examiners consider whether funds and their agents have effective policies and procedures to ensure that shareholders' transactions are processed timely and accurately, and that actual fund shares outstanding can be reconciled to the number of shares used to calculate the fund's net asset value. The following areas are among those probed during inspections:

- What are the conflicts of interest an adviser and fund transfer agent confront in processing fund shareholder transactions; how can fund shareholders be harmed by these conflicts; and how does the adviser/fund disclose, mitigate, and manage these conflicts?
- Does the fund/transfer agent have effective policies, procedures, and controls to prevent late trading and ensure the timely and accurate processing of shareholders' orders?
- Does the fund's transfer agent price orders to purchase or redeem fund shares that are received after each day's cut-off deadline using the next day's net asset value?
- Is there a daily reconciliation between the shareholder master and subsidiary ledgers and are differences resolved promptly?
- Are any transactions priced "as of" the net asset value calculated on an earlier day reviewed and approved by fund management?
- What is the process for correcting any errors that occur in net asset value? Why do errors occur?
- Are funds/shareholders being reimbursed for dilution caused by errors in the calculation of shares outstanding or net asset value?
- Is there adequate control over unclaimed dividends and redemption payments?

Anti-money laundering: Examiners consider whether funds have effective policies and procedures to detect and deter money-laundering activities, whether these policies and procedures are regularly tested for continued effectiveness, and whether actual anti-money laundering (or "AML") processes are consistent with the policies and procedures. The following areas are among those probed during inspections:

- What are the conflicts of interest an adviser, fund, and their staffs confront in establishing and maintaining effective AML programs and how do they mitigate and manage these conflicts?
- Does the adviser/fund have AML policies, procedures, and control mechanisms designed to detect transactions that raise a suspicion of money laundering or terrorism financing?
- Are those policies, procedures, and controls in writing and have they been approved by the adviser's board (or senior management) or the fund's board of directors?
- Do the policies, procedures, and controls reasonably reflect the characteristics of clients, geographic location, distribution systems, and service providers used to conduct its business?
- Where the adviser/fund has delegated the day-to-day operations of its AML program to a service provider, what due diligence has the adviser/fund performed of the service provider's AML program?
- Has the adviser/fund designated an AML compliance officer who is sufficiently experienced and has the requisite position and stature within the organization to ensure that the AML activities are comprehensive and effective?
- Does the adviser/fund have an on-going AML education and training program that is reasonably designed to ensure that all staff concerned with the organization's AML program are able to fully and effectively perform their roles in the program?
- Does the adviser/fund have an annual, independent review of the organization's AML program that is independent of the AML officer and program and is the annual review presented to the organization's board for consideration?
- Does the adviser/fund check client/customer names against government-prepared lists, such as those prepared by the Office of Foreign Asset Control and have due diligence procedures to identify the beneficial owners of any private banking clients to whom the organization provides services?
- Does the adviser/fund have effective procedures to capture and report cash transactions and suspicious activities?

Corporate governance: Examiners consider whether funds have appropriately constituted boards, whether boards meet regularly to consider matters required (*e.g.*, approval of the advisory contract, the independent auditor, fair value procedures), and whether boards appear to be effectively carrying out their fiduciary duties to fund shareholders. The following areas are among those probed during inspections:

- What are the conflicts of interest a fund's board of directors as a whole and individual directors confront in approving contracts and overseeing the activities of the fund; how can fund shareholders be harmed by these conflicts; and how does the board mitigate and manage these conflicts?
- Does a fund's board have policies, procedures, and controls for its activities?
- Is a fund's board properly constituted with independent directors? Do they meet the legal definition of independent?
- Has the board reviewed and approved all fund contracts with service providers?

- Did the board appear to have adequate information on which to base its decision to approve a contract and especially the advisory contract? Are board minutes adequate to reflect whether the board fulfilled its obligations?
- Does the board's audit committee approve and oversee the activities of the fund's outside auditor?
- Are any of the directors derelict in their attendance at board meetings?
- Has the board held required in-person meetings?

Money market funds: Examiners evaluate whether money market funds contain only high quality securities. This involves reviewing the investment process and fund assets to determine whether securities meet the high quality, short-term, dollar denominated tests and that their average maturity is 90 days or less. Examiners also review periodic testing by the fund that is designed to ensure the market-based value of its assets is consistent with using those assets' costs to calculate its daily net asset value. The following areas are among those probed during inspections:

- Do the securities in the money market portfolio meet the quality, maturity, and diversification requirements of the law?
- Are the methods used in determining creditworthiness likely to result in effective credit determinations?
- Have procedures been established to ensure that the dollar-weighted average portfolio maturity does not exceed 90 days?
- If the fund purchases unrated securities, what methods were used to determine that the instruments were comparable in quality to rated securities?
- Has the board established and adopted written procedures to ensure a stable net asset value per share?
- Do the valuation procedures provide for periodic testing of the deviation of the net asset value of the fund based on amortized cost and current market values of securities (shadow pricing)?
- Has the board established and periodically reviewed written guidelines and procedures under which the fund's investment adviser or officers make such determinations as the board may delegate to them?
- Has the board approved the downgrading of any unrated or second tier security?
- For taxable money market funds, has the board approved the purchase of each unrated security or a single rated security?
- Did a review of sales and purchases prior to and after financial reporting periods indicate window dressing?

F. Priority Areas and Mini-Sweeps

To supplement its overall risk-based approach to inspections, each year the examination staff, in conjunction with other Commission staff, establish priority areas that are reviewed during routine inspections. These priority areas may be selected to evaluate how firms have implemented a recently adopted rule, to probe an activity or an area that presents heightened investor protection issues, or to determine if a new or amended rule may be needed to address new developments or new instruments in the marketplace.

During the past five years, the following priority areas were among those reviewed by examiners: valuation practices of bank loan funds, paying costs of fund distribution, funds of hedge funds, Regulation S-P, investment allocation procedures, Regulation FD, supervisory practices (particularly of "star" portfolio managers or traders), codes of ethics, the "householding" rule, pricing services, internet advisers, practices for assuring the suitability of recommendations, correction of errors in net asset value, fund governance, the fund "Names Rule," handling shares of lost or missing security holders, switching in variable annuity contracts, AML practices, contingency planning and readiness for disasters, fair value pricing practices, performance claims by advisers, Part II of Form ADV, best execution, use of soft dollars, side-by-side management of hedge funds and other accounts, compliance with Sarbanes-Oxley provisions, and processing variable policy holder transactions.

In addition, as noted, examination staff are increasingly conducting "mini-examination sweeps" of a select number of firms, targeted to investigate a particular area. These examinations may help the staff to identify and promptly investigate an area of emerging compliance risk. The examination staff have a number of such sweeps underway currently.

V. Results of Examinations

Examinations help to protect investors in several ways. First, examinations reveal problems that lead to corrective actions by funds and advisers. Most frequently, these corrective actions involve improvements in internal controls and compliance practices to ensure that the problem is corrected and does not recur.[44] Examinations have also revealed serious problems, including fraud. Examinations may also result in funds being returned to investors. Examples of each result are summarized below. Finally, while not a quantifiable result, the prospect of a visit from examiners also helps deter misconduct.

A. Corrective Action by Funds and Advisers

As noted, examiners find violations or deficiencies during 85-90% of fund and adviser examinations. Deficiency letters outline these findings and require corrective action by the firm. Most frequently, these are improvements in compliance policies and procedures. Some examples of this corrective action follow:

- New procedures are implemented to review personal securities trading by employees.
- New "best execution" committee is formed to evaluate the order routing practices of the fund and review execution quality across markets.

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44 In order to aid and encourage firms to improve compliance practices, the staff occasionally issues public reports that describe common examination findings and that may also describe examples of good compliance controls that have been observed in examinations. *See, e.g., Joint Regulatory Sales Practice Sweep* (Mar. 1996); *Inspection Report of the Soft Dollar Practices of Broker-Dealers, Investment Advisers and Mutual Fund* (Sept. 1998); *Broker-Dealer Risk Management Practices Joint Statement* (July 1999); *Report of Examinations of Day Trading Broker-Dealers* (Feb. 2000); *Report Concerning the Display of Customer Limit Orders* (May 2000); and *Joint SEC/NASD/NYSE Report of Examinations of Broker-Dealers Regarding Discounts on Front-End Sales Charges on Mutual Funds* (Mar. 2003).

- New written policy is implemented for the allocation of hot initial public offerings; all allocations are reviewed by compliance staff; and new disclosure is made of the policy.

- New disclosure is added to Form ADV and other brochures to provide more complete disclosure of fees and charges.

- New procedure is implemented to ensure that fund shareholders receive a current prospectus when purchasing shares of the fund.

- Compliance exception reporting is enhanced to detect improper ticket charges to wrap fee client accounts.

- New procedures are implemented to ensure that principal transactions are not effected without prior client consent.

- Pricing procedures are revised and appropriate disclosures are made to clients.

- Procedural and systems changes are made to enhance the adviser's fee billing process in order to correct fee calculation errors.

B. Stopping Fraud

Examinations sometimes reveal a fraud in progress, stop the fraud, and lead to enforcement investigation (a full list of enforcement actions involving funds is attached). The following are examples of such examinations:

- An examination revealed that an adviser had fraudulently raised over $31 million from 2,000 investors in an affinity fraud targeting Caribbean Island immigrants. The SEC filed an emergency civil action against the firm, obtained an asset freeze, and subsequently barred the principal from association with any investment adviser. He pled guilty to criminal charges brought by the U.S. Attorney's office and was sentenced to five years in jail and required to pay over $27 million in restitution.[45]

- An examination revealed overpricing in portfolio securities causing the value of the portfolios to be overstated by approximately $300 million, and resulting in the portfolios paying excess management and incentive fees. Also, the performance of the portfolios was materially overstated in offering, marketing and other documents, and in filings with the Commission.[46]

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[45] SEC v. A. B. Financing and Investments, Inc., and Anthony Blissett, Litigation Release No. 18338 (Sept. 10, 2003).

[46] SEC v. Edward J. Strafaci, Litigation Release No. 18432 (Oct. 29, 2003).

- An examination revealed possible fraud violations involving recommendations of tax avoidance strategies involving over-the-counter swaps and options in transactions with offshore entities that created phantom capital losses for tax purposes, and the use of a grantor retained annuity trust, a wealth transfer device.[47]

- An examination of an investment adviser and its principal revealed significant misrepresentation as to the use of proceeds and misappropriation of investor funds. Investors were not told that one-third of proceeds went to purchase a private residence or were used to pay the adviser's business expenses.[48]

- An examination revealed that the adviser was operating an ongoing Ponzi scheme, with client monies being used to repay earlier investors and for "loans." The adviser had raised $7.6 million from known clients and others.[49]

- An examination revealed that an investment adviser principal misappropriated $500,000 of client assets and misrepresented investments, including loan transactions with exorbitant interest rates and investments in an affiliated partnership.[50]

C. Returning Funds to Investors

While the SEC's examination program does not prosecute investors' financial claims, when examiners discover overcharges, undisclosed fees, or other inappropriate payments by investors, the staff takes steps to have the funds repaid. Some examples follow.

- Examiners found that a principal of an advisory firm misappropriated $18 million of clients' assets by creating false custodian statements that were sent to clients. Following this finding and subsequent enforcement investigation, examiners assisted local criminal authorities. The investment adviser's principal was required to pay $18 million in restitution and received an enhanced prison sentence of 25 years.[51]

- An examination revealed that an investment adviser misappropriated clients' assets. The Commission barred the principal from the securities industry and ordered him to

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47 Examination No. IA2003SFDO069.

48 In the Matter of Christopher A. Lowry, Administrative Proceeding, File No 3-10390 (Aug. 30, 2002).

49 Examination No. IA2000MRO102.

50 In the Matter of James Oh, Administrative Proceeding, File No. 3-10759 (Apr. 18, 2002). *See also* SEC v. James Oh, Litigation Release No. 17428 (Mar. 21, 2002).

51 U.S. v. Thomas D. Abrams, Criminal Action No. 01-8168-CR-GRAHAM/TURNOFF (S.D. Fla. (Sept. 30, 2002).

disgorge over $1.9 million.[52] In a subsequent criminal action, he was sentenced to a five-year prison term and ordered to pay $900,000 in restitution.[53]

- Examiners discovered an adviser overcharging advisory client fees, and required the adviser to review all of its client accounts for fee calculation errors. As a result of the findings, the registrant reimbursed clients over $1.9 million and implemented documentary, procedural, and systems changes designed to enhance its fee billing process.[54]

- Examiners identified that an investment adviser and its president failed to seek best execution for customers by interposing a broker-dealer between clients and a market maker in order to compensate the broker-dealers for client referrals. This practice caused clients to pay approximately $1.7 million in unnecessary commissions. Shortly after completion of the routine examination, the adviser reimbursed $1.7 million to the clients.[55]

- Examiners found that an adviser purchased IPOs for which it was a co-managing underwriter for client accounts, without adequate disclosure to clients. As a result of the exam findings, the adviser refunded $771,077 to advisory clients and limited partners, representing, among other things, lost performance fees associated with these trades.[56]

- In an examination prompted by a media report, examiners found that the firm's president failed to provide documentation on checks and wire transfers from client accounts, and identified misappropriation of over $9 million in client assets and $20 million in unauthorized transfers among client accounts. The SEC brought a civil injunctive action resulting in an order to pay $14.4 million. Criminal action was also brought (resulting in a conviction and a 57-month prison term).[57]

VI. Improving Fund Compliance

While SEC examinations may periodically review certain aspects of a fund's activities, ensuring compliance on a day-to-day basis is the responsibility of fund management, the fund's board, and

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52 In the Matter of Vector Index Advisors, Inc. and Steven H. Adler, Investment Company Act Release Nos. 25268 (Nov. 15, 2001) and 25269 (Nov. 15, 2001).

53 U.S. v. Steven H. Adler, Litigation Release No. 17833 (Nov. 8, 2002).

54 Examination No. IA2002NERO092.

55 In the Matter of Portfolio Advisory Services, LLC, And Cedd L. Moses, Administrative Proceeding File No. 3-10807 (June 20, 2002).

56 Examination No. IA1999NERO111.

57 SEC v. Dana C. Giacchetto and the Cassandra Group, Litigation Release No. 17092 (Aug. 6, 2001).

the investment adviser. The Commission has adopted new rules designed to improve compliance by funds and advisers, with the goal of preventing violations from occurring.

As noted previously, in December, 2003, the Commission adopted a new rule requiring all funds and advisers to implement and maintain written policies and procedures reasonably designed to prevent, detect, and correct violations of the federal securities laws, to review those policies and procedures annually for their adequacy and the effectiveness of their implementation, and to designate a chief compliance officer to be responsible for administering the policies and procedures.[58] The rule requires that the chief compliance officer be responsible to the fund's board, and provide a written report each year to the board concerning material compliance matters. This rule is designed to protect investors by ensuring that all funds and advisers have internal programs for compliance with the federal securities laws, as well as providing fund boards with more information to exercise their compliance oversight responsibilities.

In December 2003, the Commission also proposed a rule that would require enhanced disclosure requirements.[59] These enhancements would require funds to specifically disclose market timing policies and procedures, practices regarding "fair valuation" of their portfolio securities, and policies and procedures with respect to the disclosure of their portfolio holdings. This type of explicit disclosure would shed light on market timing and selective disclosure of portfolio holdings so that investors could better understand the fund's policies and how funds manage the risks in these areas, and would also allow examiners to better determine if the fund's actions are consistent with its disclosures.

The Commission is also considering other ways to enhance compliance by funds and advisers, including by requiring funds and advisers to periodically undergo a compliance audit by an independent third party.[60] Other concepts include the creation of a self-regulatory organization for advisers, and that advisers obtain and maintain fidelity bond protection.[61]

VII. Conclusion

The SEC examines funds and advisers, using a risk-based methodology. Examinations reveal a variety of problems and result in corrective action by funds and advisers, as well as enforcement

58 *See supra* n.34 and accompanying text.

59 *See SEC, Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings,* Securities Act Release No.8343, Investment Company Act Release No.26287 (Dec. 11, 2003); *see also* 68 Fed. Reg. 70402 (Dec. 17, 2003).

60 *See* Chairman William H. Donaldson, Regulatory Reforms to Protect Our Nation's Mutual Fund Investors, testimony before the U.S. Senate Committee on Banking, Housing and Urban Affairs (Nov. 18, 2003).

61 In February 2003, in tandem with the rule proposal concerning compliance policies and procedures and compliance officers, the Commission sought comment on these concepts. *See SEC, Compliance Programs of Investment Companies and Investment Advisers,* Investment Company Act Release No. 25925, Investment Advisers Act Release No. 2107 (Feb. 5, 2003); *see also* 68 Fed. Reg. 7038 (Feb. 11, 2003). The Commission considers these as viable options. *See Compliance Programs of Investment Companies and Investment Advisers, supra* at n.34.

actions in the most serious cases. Examinations are a critical component in investor protection, and the SEC is taking steps to enhance its ability to detect abusive conduct in a timely manner. The SEC has enhanced its examinations of funds and advisers. In light of misconduct involving market timing, Commission examiners have added new examination steps to routine examinations. In addition, with additional staffing recently added to the examination program, examiners are increasing the frequency and depth of examination reviews for high risk firms, better using technology and data in examinations, giving examiners discretion to identify new or emerging areas of compliance risk, conducting more targeted "mini-sweep" examinations to identify risk areas sooner, and working closely with other staff at the Commission to highlight problems detected, and identify possible solutions sooner.

Appendix A: Enforcement Actions Involving Mutual Funds

APPENDIX A

ENFORCEMENT ACTIONS INVOLVING MUTUAL FUNDS

A. Market Timing, Late Trading, and/or Selective Disclosure

1. **SEC v. Invesco Funds Group**, Litigation Release No. 18482 (Dec. 2, 2003). The Commission alleged that Invesco, an investment adviser, and its chief executive officer ("CEO"), Cunningham, fraudulently accepted investments by market timers in certain mutual funds in order to earn higher management fees. Invesco entered into specific arrangements with certain investors, which permitted the investors to market time in the funds. The arrangements were contrary to disclosures in the funds' prospectuses. Further, the adviser did not enforce the market timing limitations as described in the prospectuses for shareholders with smaller accounts. The Commission also alleged that the Invesco and Cunningham had a fiduciary duty to act in the best interests of the funds and to provide full disclosure. However, neither disclosed the special arrangements with the shareholders of the funds or the funds' independent directors. The Commission is seeking permanent injunctions, disgorgement, and civil penalties.

2. **SEC v. Security Trust Company**, Litigation Release No. 18479 (Nov. 25, 2003). Security Trust Company ("STC") is an uninsured national banking association that, among other things, effects mutual fund trades for participants in retirement plans and processes data regarding those trades for the plans' third-party administrators. The Commission alleged that STC and certain principals facilitated late trading in nearly 400 different mutual funds by several hedge funds ("Canary Funds") and also attempted to conceal the Canary Funds' market timing activities from mutual funds using various methods including: (a) shotgun, (b) omnibus, (c) taxpayer ID, and (d) piggybacking. The Commission also alleged that STC had a compensation arrangement with the Canary Funds that included a larger than usual custodial fee and a profit sharing arrangement with respect to the Canary Funds' trades. The Commission is seeking an accounting, disgorgement, and penalties from all of the defendants and a judgment of permanent injunction against the principals.

3. **SEC v. Gary L. Pilgrim, Harold J. Baxter and Pilgrim Baxter & Associates, Ltd.,** Litigation Release No. 18474 (Nov. 20, 2003). The Commission charged Pilgrim Baxter & Associates, Ltd., a registered investment adviser, and certain of its principals (Gary Pilgrim and Harold Baxter) with fraud and breach of fiduciary duty in connection with market timing in certain funds ("PBHG Funds"). Both Pilgrim and Baxter were officers of the adviser. Pilgrim was also an officer of the PBHG Funds and Baxter was a trustee of the Funds. PBHG Funds had a limit of four exchanges out of the Funds into a cash management fund per year. The Commission alleged that the respondents permitted a hedge fund in which Pilgrim and his wife had a substantial interest to engage in market timing of a PBHG Fund that Pilgrim managed. In addition, the Commission alleged that Baxter provided non-public information concerning one PBHG Fund to a close friend in the brokerage business. The friend passed the information on to customers who used the information to market time the BBHG Funds and to exercise hedging strategies through other financial and brokerage institutions. The Commission seeks permanent injunctive relief, disgorgement, prejudgment interest, and civil penalties, as well as a prohibition against Pilgrim and Baxter from acting in certain enumerated positions with a mutual fund.

4. **In the Matter of Putnam Investment Management, LLC**, Investment Company Act Release Nos. 26255 (Nov. 13, 2003) and 26232 (Oct. 28, 2003). In settled administrative proceedings, the Commission found that at least six employees of Putnam, a registered investment adviser, engaged in market timing of mutual funds in their personal accounts. Four of these employees engaged in trading in funds over which they had investment decision-making responsibility and had access to non-public information regarding, among other things, current portfolio holdings and valuations and transactions not readily available to all fund shareholders. The Commission found that Putnam became aware that several investment management employees were engaging in market timing the funds, but Putnam failed to disclose the practice to the boards of directors of the funds and to the shareholders; and Putnam also failed to take adequate steps to detect and deter such trading activity through its own internal controls and its supervision of investment professionals. Putnam was ordered to cease and desist from committing or causing future violations, ordered to pay restitution, and ordered to comply with a myriad of undertakings to ensure future compliance. The amount of penalty Putnam shall pay is to be determined at a later date.

5. **SEC v. Justin M. Scott and Omid Kamshad**, Litigation Release No. 18428 (Oct. 28, 2003). In a district court action related to Section A.4., above, the Commission alleged that two employees of Putnam engaged in trading in funds over which they had investment decision-making responsibility and had access to non-public information regarding, among other things, current portfolio holdings and valuations and transactions not readily available to all fund shareholders. Further, the defendants failed to disclose their trading and that, by their trading, they potentially harmed other fund.

6. **SEC v. Martin J. Druffner**, Litigation Release No. 18444 (Nov. 4, 2003). The Commission alleged that five brokers formerly employed by Prudential Securities, Inc. defrauded mutual funds and their shareholders by misrepresenting their identities or the identities of their customers in connection with market timing trades after the mutual funds had restricted or blocked the brokers or their customers from further trading. In addition, the Commission alleged that a former branch manager of Prudential assisted the brokers by, among other things, approving their market timing trades. The Commission is seeking injunctive relief, disgorgement, penalties, and other equitable relief as the court deems appropriate.

7. **In the Matter of James Patrick Connelly, Jr.**, Investment Company Act Release No. 26209 (Oct. 16, 2003). The respondent in this administrative proceeding was a former officer of a registered investment adviser that managed a complex of funds. He approved agreements permitting certain investors to market time in the funds despite language in the funds' filings with the Commission that such activity would be discouraged and limiting exchanges among the funds. The Commission ordered Connelly to: (a) cease and desist from committing or causing violations Investment Company Act; (b) pay a civil penalty of $400,000; and (c) be barred from the broker-dealer, investment adviser, and fund industries.

8. **In the Matter of Steven B. Markovitz**, Advisers Act Release No. 2180 (Oct. 2, 2003). The Commission found that the respondent was a hedge fund trader who engaged in late trading of mutual fund shares on behalf of certain hedge funds. Certain broker-dealers enabled and permitted the respondent to communicate orders to purchase and sell mutual fund shares

before 4:00 p.m. and then confirm, alter, or cancel the proposed orders after 4:00 p.m. In some cases, Markovitz would communicate orders to the broker-dealers in the first instance after 4:00 p.m. The Commission ordered Markovitz to cease and desist from future violations, and was barred from the investment adviser and mutual fund industries.

9. **In the Matter of Charles Sihpol, III,** Investment Company Act Release No. 26179 (Sept. 16, 2003). Enforcement alleged that Sihpol, a former employee of Banc of American Securities LLC ("BAS") played a key role in enabling Canary Capital Partners, LLC; Canary Capital Partners, Ltd.; Canary Investment Management, LLC; and Edward J. Stern (collectively, "Canary") to engage in late trading of mutual fund shares. In addition, Enforcement alleged that Sihpol falsified, altered, destroyed, or evaded the creation of books and records that BAS was required to create, maintain, and preserve. Specifically, beginning around May 2001, Canary began manually to late trade BAS mutual funds. Sihpol (or a member of his team) would prepare and time stamp order tickets for proposed trades prior to 4:00 p.m. ET (when the BAS mutual funds priced their shares). Canary would decide whether to carry out the trades after 4:00 p.m. and at that time, and Sihpol (or a member of his team) would either use the order tickets to effect Canary's trades or would discard the tickets if Canary decided not to execute the trades. In the summer of 2001, BAS technicians installed an electronic direct access system in Canary's offices. Through this system, Canary was able to enter its trades directly into BAS' clearing function until 6:30 p.m. ET, and was able to late trade the BAS mutual funds with which BAS had clearing agreements. Canary used the electronic system to late trade mutual funds until the summer of 2003 and continued to trade manually whenever there were technical problems with the electronic system.

10. **In the Matter of Alliance Capital Management, L.P.**, Investment Advisers Act Release No. 2205 (Dec. 18, 2003). The Commission found that Alliance Capital, a registered investment adviser to several mutual funds as well as a sponsor and manager of several hedge funds, provided "timing capacity" in its mutual funds to known timers in return for, or in connection with, the timers' investments of "sticky assets" in Alliance Capital hedge funds or other investment vehicles from which Alliance Capital earned management fees. The prospectuses for the mutual funds gave the misleading impression that Alliance Capital sought to prevent timing in these mutual funds. In addition, Alliance Capital provided material nonpublic information the portfolio holdings of certain mutual funds to at least one of the timers, thus enabling the timer to profit from market timing in declining markets. The Commission settled the matter by obtaining significant remedial undertakings and $250 million in disgorgement and penalties, which the Commission contemplates will be distributed to injured shareholders pursuant to a Fair Fund distribution.

11. **In the Matter of Massachusetts Financial Services, Co.,** Investment Advisers Act Release No. 2213 (Feb. 5, 2004). The Commission found that Massachusetts Financial Services ("MFS"), an investment adviser and sponsor of hundreds of mutual funds, permitted widespread market timing of certain mutual funds, internally referred to as "Unrestricted Funds," despite prospectus disclosure that MFS funds "do not permit market timing or other excessive trading practices." John Ballen, president and CEO of MFS, approved, and Kevin Parke, chief investment officer, implemented MFS's policy permitting market timing in its Unrestricted Funds during the same period that they signed registration statements for certain Unrestricted

Funds that purportedly prohibited market timing. The respondents also failed to disclose the conflict of interest created by MFS's acceptance of investments from timers contrary to the interests of long-term shareholders. The Commission settled the matter by obtaining significant remedial undertakings and over $225 million in disgorgement and penalties, which the Commission contemplates will be distributed to injured shareholders pursuant to a Fair Fund distribution.

12. **SEC v. Security Brokerage, Inc. and Daniel Calugar**, Litigation Release No. 18524 (Dec. 24, 2003). The Commission filed civil fraud charges against Security Brokerage and its president and majority owner Calugar, for their participation in a scheme to defraud mutual fund shareholders through improper late trading and market timing. The Commission alleges that from at least 2001 to 2003, Calugar, trading through Security Brokerage, reaped profits of approximately $175 million from improper late trading and market timing, principally through mutual funds managed by Alliance Capital Management and Massachusetts Financial Services. Based on the Commission's application, the court issued a temporary restraining order freezing the assets of the defendants, prohibiting the destruction of documents, and granting expedited discovery.

13. **In the Matter of Paul A. Flynn**, Investment Advisers Act Release No. 2212, (Feb. 3, 2004). In this administrative proceeding, Enforcement alleged that from 2001 to 2003, Flynn, while employed as a Managing Director of Equity Investments at Canadian Imperial Bank of Commerce ("CIBC"), substantially assisted Security Trust Company, N.A. and CIBC hedge fund clients, including Canary Capital Partners, LLC, in engaging in late trading and deceptive market timing of mutual fund shares. Enforcement alleges that Flynn knew or was reckless in not knowing that CIBC's hedge fund clients were engaging in late trading and deceptive market timing, and further that he arranged financing for the hedge fund clients.

14. **SEC v. Columbia Management Advisors, Inc. and Columbia Funds Distributor, Inc.**, Litigation Release No. 18590 (Feb. 24, 2004). The Commission filed a civil action alleging that, from 1998 through 2003, Columbia Management Advisors, Inc., a registered investment adviser that manages Columbia mutual funds, and Columbia Funds Distributor Inc., a registered broker-dealer that is the principal underwriter and entity responsible for selling the funds, made arrangements to allow preferred mutual fund customers to engage in short-term and excessive trading, while at the same time falsely representing publicly that it prohibited such trading. Columbia Management Advisors and Columbia Funds Distributor are subsidiaries of FleetBoston Financial Corporation. Columbia Management Advisors and Columbia Funds Distributor accepted "sticky assets" in connection with certain of the arrangements.

15. **SEC v. Mutuals.com, Inc.**, Litigation Release No. 18489 (Dec. 4, 2003). The Commission filed civil fraud charges against Mutuals.com, Inc., its CEO, its president, and its compliance officer, as well as two affiliated broker-dealer firms. The Commission alleged that the defendants deceived hundreds of mutual fund companies and their shareholders by improperly helping institutional brokerage customers and advisory clients carry out thousands of market timing trades and illegal late trades in shares of those mutual funds.

B. Misappropriation

1. SEC v. John J. Lawbaugh, Litigation Release No. 18377 (Sept. 30, 2003). The Commission alleged that Lawbaugh, a principal of two face-amount certificate companies (1st Atlantic Guaranty Corporation and SBM Certificate Company), overstated the value of assets and failed to disclose transfers in certain filings with the Commission made by the face-amount certificate companies. These misrepresentations and omissions hid the fact that Lawbaugh misappropriated approximately $2 million for his own use. Further, the Commission alleged that Lawbaugh misappropriated approximately $1 million from investors by promising to invest their money in certificates of one of the face-amount companies. The money was not invested as promised.

2. In the Matter of Vector Index Advisors, Inc. and Steven H. Adler, Investment Company Act Release Nos. 25269 (November 15, 2001) and 25268 (Nov. 15, 2001). Adler was a principal of a registered investment adviser, Vector, and a registered investment company, ASM, and was also associated with a registered broker-dealer. Adler promised investors that he would use their money to buy and sell shares of ASM. Adler also told investors that he would maintain "market timing" accounts through Vector and that he would maximize investor returns by correlating the purchase and sale transactions to fluctuations in the markets. However, Adler misappropriated investor money to pay for expenses of Vector and his own expenses. Adler also prepared and furnished to investors fictitious monthly statements purportedly reflecting gains in their accounts. The Commission ordered Adler to cease and desist from future violations, and barred him from the broker-dealer, investment adviser, and fund industries. In a related action, **U.S. v. Steven H. Adler**, Litigation Release No. 17833 (Nov. 8, 2002), the United States Attorney's Office for the Middle District of Florida indicted Adler. Adler was convicted of mail and wire fraud and sentenced to jail.

C. Misrepresentations and/or Omissions

1. SEC v. Irving Paul David, Litigation Release No. 18300 (Aug. 21, 2003). From January 2001 through January 2003, David, formerly an officer of two investment companies, engaged in two schemes to embezzle money from the Consulting Group Capital Markets Funds and Smith Barney World Funds. At the very time that he was embezzling from the funds, David signed a certification pursuant to the Sarbanes-Oxley Act in which he falsely stated that he had disclosed to the Consulting Group Fund's auditors and audit committee any fraud, whether material or not, involving management. In fact, he had made no such disclosure. The Commission seeks permanent injunctive relief, disgorgement of ill-gotten gains with prejudgment interest, and civil penalties.

2. In the Matter of Vector Index Advisors, Inc. and Steven H. Adler, Investment Company Act Release Nos. 25269 (Nov. 15, 2001) and 25268 (Nov. 15, 2001). *See* Section B.2, above.

3. In the Matter of ND Money Management, Inc.; Ranson Capital Corporation; Robert E. Walstad; and Monte L. Avery, Investment Company Act Release No. 25523 (Apr. 12, 2002. Two registered investment advisers (ND Money Management and Ranson Capital) managed several registered state municipal bond funds. The Commission found that the funds'

disclosure was misleading because they invested contrary to certain investment restrictions, and that there were reporting violations under the fund's code of ethics and certain books and records violations. A principal of the Funds, Robert Walstad, and a portfolio manager of the funds, Monte Avery, were responsible for these violations. The Commission ordered: (a) the respondents be censured and ordered them to cease and desist from committing or causing any future violations; (b) ND Money Management, Ranson Capital, Walstad and Avery to pay civil penalties of $10,000, $10,000, $15,000 and $5,000, respectively; and (c) ND Money Management and Ranson to hire a consultant to conduct a review and follow-up reviews for four years.

4. **In the Matter of Lawrence P. Grady**, Investment Company Act Release No. 25201 (Sept. 28, 2001). Grady was the president, director, and sole employee of Minn Shares, Inc., a fund. Enforcement alleged that Grady made management decisions for the fund and was personally responsible for ensuring the fund's compliance with the Investment Company Act. Enforcement alleged that for a period of time the fund operated without a written code of ethics, that Grady failed to report his and his wife's personal securities transactions to the fund, and that Grady caused the fund to operate without a fidelity bond. In addition the fund did not file a proxy with the Commission and failed to transmit to shareholders semi-annual reports. Further, Enforcement alleged that Grady caused an affiliated person of the fund to engage in a prohibited transaction with the fund and made untrue statements of material fact about the fund's compliance with the Investment Company Act to fund shareholders in two proxy statements. The Commission ordered Grady to cease and desist from committing or causing any future violations, barred him from the mutual fund industry for three years, and ordered him to pay a penalty $10,000.

5. **SEC v. Michael Carnicle, Michael Hansen, William Straughan, Randy Glad, Lionel Reifler, Howard Ray, and Arie From,** Litigation Release No. 16293 (Sept. 27, 1999). The Commission alleged that Carnicle secretly established and controlled two Los Angeles-based mutual funds and knowingly made misrepresentations and omissions of material fact, including falsely representing that only 10% of the funds' monies would be invested in "illiquid" securities and that "exchange" transactions would only be conducted under limited circumstances. The court found that the Commission had demonstrated that it is entitled to all of the relief it sought against Carnicle: a permanent injunction, full disgorgement of the $444,323 Carnicle received in margin loans plus prejudgment interest, and the maximum third-tier penalty equal to Carnicle's pecuniary gain of $444,323. Similarly, the court found that the Commission was entitled to the second-tier penalties of $20,000 each that it sought against defendants Howard Ray and Randy Glad, who had previously been enjoined by default.

6. **In the Matter of Michael P. Traba**, Investment Company Act Release Nos. 23952 (Aug. 19, 1999) and 23595 (Dec. 10, 1998). Enforcement alleged that Traba, the portfolio manager of two bank-advised money market funds, caused both funds to hold structured notes whose values decreased significantly in 1994 as interest rates rose. As a result of the declining value of the derivatives, both funds ultimately broke a dollar. To hide the funds' losses, Enforcement alleged that Traba (1) instructed the funds' administrator to use amortized cost to value these derivatives under the required shadow pricing procedures; and (2) sold the derivatives to certain of the bank's common trust accounts at par, and resold them to another

bank account at a loss. In connection with this matter, the Office of the Comptroller of the Currency prohibited him from participating in the conduct of the affairs of an insured depository institution and ordered him to pay a $15,000 civil money penalty. The Commission ordered Traba to cease and desist from committing or causing violations and any future violations of the securities laws and to pay a penalty in the amount of $15,000, and barred him from association with any broker, dealer, or investment company.

7. **In the Matter of The Rockies Fund, Inc.; Stephen G. Calandrella; Charles M. Powell; Clifford C. Thygesen; and John C. Power**, Investment Company Act Release No. 26202 (Oct. 2, 2003); Initial Decision Release No. 181 (March 9, 2001). The Rockies Fund was a business development corporation and its board of directors consisted of Calandrella and two independent directors, Powell and Thygesen. Enforcement alleged that the fund and the three directors defrauded investors by materially overstating the fund's net assets. The overstatement of assets stemmed from: (1) the fund's improper classification of portfolio securities of Premier Concepts, Inc. ("Premier") as unrestricted; (2) the fund's improper claim of ownership of certain restricted Premier stock; and (3) a manipulation, by Calandrella and Powell, of the market for Premier stock by engaging in matched order and wash sales or trading through nominee accounts. Enforcement also alleged that the fund filed false and misleading annual and quarterly reports and that Calandrella improperly accepted compensation for the fund's purchase of Premier stock in that he caused the fund to enter into an agreement to pay money to one of his business acquaintances in return for, among other things, the acquaintance's agreement to forego a potential legal claim against Calandrella. In an initial decision, which the Commission upheld, the administrative law judge ("ALJ") ordered, among other things, that the respondents cease and desist from committing or causing future violations, that Calandrella be barred from associating with an investment company, that Powell and Thygesen be prohibited from associating with an investment company for three years, and that Calandrella, Powell, and Thygesen pay a civil penalty of $500,000, $160,000, and $160,000, respectively.

8. **In the Matter of Piper Capital Management, Inc.; Worth V. Bruntjen; Marijo A. Goldstein; Robert H. Nelson; Amy K. Johnson; Molly Destro; and Edward J. Kohler,** Advisers Act Release No. 2163 (Aug. 26, 2003); Initial Decision Release No. 175 (Nov. 30, 2000); **In the Matter of Worth V. Bruntjen**, Investment Company Act Release No. 23664 (Jan. 26, 1999) and Advisers Act Release No. 1737 (July 28, 1998). Enforcement alleged that from approximately early 1992 through at least April 1994, Piper Capital Management, Inc. ("PCM"), the investment adviser to a government bond fund, and Bruntjen and Goldstein, the fund's portfolio managers, committed fraud by making false and misleading statements to investors regarding the risks associated with an investment in the fund and the leveraging of fund assets. The order alleges that, despite its conservative investment objective, the fund was in fact a high-risk investment as a result of PCM's, Bruntjen's, and Goldstein's investment of fund assets in interest rate-sensitive collateralized mortgage obligation derivatives. In addition, the order alleges that PCM, Bruntjen, and Goldstein caused the fund to change its investment objective without shareholder approval. PCM and Bruntjen committed fraud by making false statements to investors regarding Bruntjen's educational background in PCM's amendments to its Forms ADV. Kohler, president of PCM and supervisor of Bruntjen and Goldstein during the relevant time period, failed reasonably to supervise Bruntjen, and Goldstein with a view to preventing their violations of the federal securities laws.

The Commission settled with Bruntjen, and he was ordered to cease and desist from committing or causing future violations and to pay a penalty of $100,000. In addition, the Commission barred him from the securities industry. In the litigated aspect of the case, Commission upheld the ALJ's order that: (1) revoked PCM's registration; (2) ordered PCM to pay a penalty of $2,005,000; (3) censured the individual defendants (Goldstein, Nelson, Johnson, and Destro); and (4) ordered them to cease and desist from committing or causing any future violations.

9. <u>In the Matter of Terence Michael Coxon, Alan Michael Sergy, World Money Managers and World Money Securities, Inc.</u>, Advisers Act Release Nos. 2161 (Aug. 21, 2003) and 1857 (Mar. 2, 2002); Initial Decision No. 140 (Apr. 1, 1999); and Advisers Act Release No. 1604 (Jan. 13, 1997). Enforcement alleged that the certain fund affiliates had unlawfully engaged in practices concerning the fund's tax planning strategy, the allocation of fund operating expenses, the allocation of certain fund distribution expenses, the manufacture of tax equalization credits, the fund's investment policies; and had materially misrepresented those practices or the risks associated with those practices in the fund's advertising and promotional materials.
The Commission ordered: (1) the investment adviser and Coxon to cease and desist from committing or causing any future violations; (2) the investment adviser and Coxon to disgorge a total of $971,777.54 and pay prejudgment interest; and (c) the Division of Enforcement to submit a plan for the administration and distribution of the disgorgement funds. The Commission dismissed the proceedings against Sergy who was suffering from a serious, progressive disability and was no longer in the securities industry.

10. <u>In the Matter of Fundamental Portfolio Advisors, Inc.; Lance M. Brofman; and Fundamental Service Corporation</u>, Advisers Act Release No. (July 15, 2003); Initial Decision Release No. 180 (Jan. 29, 2001); and Exchange Act Release No. 39158 (Sept. 30, 1997). Enforcement alleged that Fundamental Portfolio Advisors, Inc. ("FPA"), a registered investment adviser; Malanga, FPA's president; Brofman, the former portfolio manager of the Fundamental U.S. Government Strategic Income Fund; and Fundamental Service Corporation ("FSC"), a registered broker-dealer affiliated with FPA, which distributes and markets the fund, violated certain antifraud provisions of the federal securities laws because they marketed the fund as a safe investment, offering relative stability of net asset value ("NAV"), when it was not. Enforcement also alleged that FPA, Brofman, and Malanga failed to disclose FPA's soft dollar arrangements to the board of the fund and other funds managed by FPA when questioned about such arrangements at three board meetings. The Commission upheld an ALJ order that: (1) Brofman, FPA, and FSC to cease and desist from committing or causing any violations certain provisions of the securities laws; (2) Brofman to pay a civil penalty of $250,000; (3) FPA and FSC to each pay a civil penalty of $500,000; (4) Brofman to be barred from association with any broker, dealer, investment adviser, or investment company; (5) the registration of FPA as an investment adviser to be revoked; and (6) the registration of FSC as a broker or dealer to be revoked.

11. <u>In the Matter of Fundamental Portfolio Advisors, Inc.; Lance M. Brofman; Vincent J. Malanga; and Fundamental Service Corporation</u>, Advisers Act Release No. 1729 (July 7, 1998). In a matter related to C.10., above, the Commission suspended Malanga from the

industry in any capacity for 12 months; barred him from being a supervisor or owner for two years; ordered him to pay a $25,000 civil penalty; and ordered him to cease and desist from committing or causing any future violations.

12. **In the Matter of Javed Anver Latef and Larry Alan Stockett**, Advisers Act Release No. 2116 (Mar. 20, 2003); **and In the Matter of Hudson Investor Funds, Inc.; Hudson Advisers, Inc.; Javed Anver Latef; and Larry Alan Stockett**, Initial Decision No. 139 (Mar. 30, 1999). Enforcement alleged that Latef was the president and director of the Hudson Investor Funds, a registered investment company, and president and sole shareholder of Hudson Advisers, a registered investment adviser, and Hudson Management, Inc. Stockett (through a fictitious company) was given the option to purchase the common stock of Hudson Management and Hudson Advisers for $100 each, and in return the fictitious company would pay the costs of expenses of operating the fund to the extent that fees available from the fund were not sufficient to cover those fees and expenses. Enforcement alleged that, after signing the agreements, Latef discovered that the fictitious company had never been incorporated, but both men acted as though the agreements were valid. Hudson Adviser's ADV did not disclose the financing arrangement with Stockett. In addition, a special edition of the New Industrialist magazine contained an application to invest in the fund and inaccurate information about the fund. Latef took no steps to correct inaccuracies in the front-page article and accepted investment applications from the magazine. The ALJ: (1) ordered the respondents to cease and desist from committing or causing future violations; (2) suspended Latef from associating with an investment adviser or investment company for three months; (3) barred Stockett from associating with any broker, dealer, municipal securities dealer, investment adviser, and investment company; and (4) ordered that Stockett pay a $50,000 penalty. The Commission, however, found that the charges against Stockett were not supported and dismissed the charges with respect to him.

13. **In the Matter of Scudder Kemper Investments, Inc. and Gary Paul Johnson,** Advisers Act Release No. 1848 (Dec. 22, 1999); and **In the Matter of Michael T. Sullivan, III,** Advisers Act Release No. 1849 (Dec. 22, 1999). Enforcement alleged that Sullivan, a former trader at Scudder's Boston derivatives trading desk, initiated over 100 unauthorized derivatives transactions, including the accounts of several registered investment companies. Although Sullivan had been given limited discretion to execute a derivatives trading strategy in these accounts, he repeatedly ignored loss limits and other limits. Sullivan concealed his activities by miscoding order tickets, forging the signatures of the portfolio managers on order tickets, and in some instances by not submitting any order ticket at all. Sullivan's unauthorized trading caused the investment companies to be exposed to a higher level of risk than that regarded by the portfolio managers as appropriate. Enforcement alleged that Scudder, through supervisor Johnson, failed reasonably to supervise Sullivan.

The Commission found that Scudder and Johnson failed reasonably to supervise the trader, and that Scudder aided and abetted and caused Sullivan's violations. Sullivan was barred from association with any investment adviser or registered investment company for five years. (A civil penalty was not imposed because of Sullivan's inability to pay.) Johnson was suspended from association with any investment adviser for three months and was suspended from acting in any supervisory capacity with any investment adviser for nine months. In addition, Johnson was

ordered to pay a civil fine of $10,000. Scudder was censured and ordered to cease and desist from committing or causing any future violations, ordered to pay a civil fine of $250,000, and ordered to comply with its undertaking to maintain enhanced supervisory and policies and procedures. Sullivan was ordered to cease and desist from committing or causing any violation or any future violation of the applicable securities laws.

14. **In the Matter of Stephen H. Brown**, Advisers Act Release No. 1751; Investment Company Act Release No. 23434 (Sept. 14, 1998). *See also* **In the Matter of Mitchell Hutchins Asset Management,** Advisers Act Release No. 1654; Investment Company Act Release No. 22805 (Sept. 2, 1997). Brown managed the PaineWebber Short-Term U.S. Government Income Fund, which Mitchell Hutchins (a registered investment adviser and broker-dealer) marketed as a higher-yield and somewhat higher- risk alternative to money market funds and bank certificates of deposit. Brown violated the antifraud provisions of the federal securities laws when he invested the fund's assets in securities that exposed investors to significantly higher levels of risk than had been disclosed in the fund's offering materials. The Commission ordered Brown to cease and desist from future violations, and was barred from association with an investment adviser, investment company, broker, dealer, or municipal securities dealer for three years.

D. Conflicts of Interest

1. **In the Matter of Deutsche Asset Management, Inc.,** Advisers Act Release No. 2160 (Aug. 19, 2003). Enforcement alleged that Deutsche Asset Management ("DeAM"), the investment advisory unit of Deutsche Bank, AG, failed to disclose a material conflict of interest in its voting of client proxies for the 2002 merger between Hewlett-Packard Company ("HP") and Compaq Computer Corporation. Unbeknownst to DeAM's advisory clients, Deutsche Bank's investment banking division was working for HP on the merger, and had intervened in DeAM's proxy voting process on behalf of HP. This created a material conflict of interest for DeAM, which had a fiduciary duty to act solely in the best interests of its advisory clients. The Commission found that DeAM violated the Investment Advisers Act by voting client proxies in connection with the merger without first disclosing the circumstances of its investment banking affiliate's work for HP on the proposed merger and its intervention in DeAM's voting process. The Commission censured DeAM, ordered it to cease and desist from committing or causing any violations or future violations, and ordered it to pay a $750,000 penalty.

2. **In the Matter of Zion Capital Management, LLC and Ricky A. Lang,** Investment Advisers Act Release Nos. 2003 (Dec. 20, 2001) and 2200 (Dec. 11, 2003). Enforcement alleged that Zion Capital Management ("Zion"), an investment adviser, and Lang, the president and sole owner of Zion, allocated more profitable trades to an entity in which Lang had a financial interest ("Lang entity") and more unprofitable trades to Zion's advisory client, a hedge fund. As a result, during a nine-month period, Zion's client lost more than 60% of its investment while the Lang entity made a substantial profit. Enforcement also alleged that Zion and Lang misrepresented their trading strategy and methods for resolving conflicts of interest to investors in offering and other materials.

Among other things, the Commission found that Zion and Lang misrepresented that they would employ a similar trading strategy for the client and the Lang entity, and in fact, Lang repeatedly assigned better trades to the Lang entity and worse trades to the advisory client. The Commission concluded that Lang's trading created an actual conflict of interest between the advisory client and the Lang entity. The Commission barred Lang from association with an investment adviser or investment company, and further ordered Lang and Zion to cease and desist committing future violations, to pay jointly and severally disgorgement of $210,000 plus prejudgment interest, and to pay a joint and several penalty of $220,000, which shall become part of a disgorgement fund for the victims pursuant to the Fair Fund provision of the Sarbanes-Oxley Act of 2002.

E. Compliance

1. SEC v. 1st Atlantic Guaranty Corporation, Litigation Release No. 18103A (Apr. 25, 2003). 1st Atlantic was registered with the Commission as a face-amount certificate company. The Commission alleged that, as a result of the transfer of certain assets previously held by it, 1st Atlantic operated with reserves below the legal minimum required by the Investment Company Act. The Commission also alleged that between 1998 and 2002, the former CEO and chairman of 1st Atlantic diverted approximately $1 million from 1st Atlantic and transferred assets with a value of more than $2.8 to a subsidiary without consideration. In an attempt to cover its reserve deficiency, 1st Atlantic began to improperly count the value of the common stock of its subsidiary (Subsidiary) as a "qualified investment." However, the stock of the Subsidiary was not a qualified investment as defined by the Investment Company Act and should not be counted by 1st Atlantic towards its reserve requirement. Without this asset, 1st Atlantic did not meet its reserve requirements. Although the matter is in litigation, the court has already granted a temporary restraining order and a freeze on payment to certificate holders, and scheduled a hearing on the Commission's motion for an appointment of a receiver.

2. In the Matter of Gintel Asset Management, Inc.; Gintel & Co. LLC; Robert M. Gintel; and Stephen G. Stavrides, Investment Company Act Release No. 25798 (Nov. 8, 2002). Enforcement alleged that Gintel, a portfolio manager of a registered investment adviser, Gintel Asset Management, effected at least 40 cross trades on a principal basis between an investment company and accounts in which he had an ownership interest. Gintel Asset Management also engaged in prohibited principal transactions by causing client portfolios not affiliated with Gintel to trade with accounts in which Gintel had a substantial ownership stake, including the fund. Gintel Asset Management's principal transactions also rendered false a number of statements to clients and prospective clients representing that Gintel Asset Management did not engage in any affiliated or principal transactions. Stavrides, Gintel Asset Management's president and compliance officer, prepared and signed the Commission filings containing the false statements. In addition, Gintel engaged in personal trading in securities, frequently within seven days of trades in the same securities by the fund and other clients, in violation of the fund and Gintel Asset Management's code of ethics. Stavrides failed to apply the code of ethics' blackout periods for personal trading to Gintel, Gintel Asset Management, and an affiliated broker-dealer (Gintel & Co.) and also failed to establish, maintain, and enforce procedures reasonably designed to ensure that material non-public information was not misused.

Among other things, the respondents were censured, ordered to cease and desist committing or causing future violations, and ordered to pay a total of disgorgement, interest and penalties of approximately $925,000. The Commission also prohibited Gintel Asset Management from soliciting or advertising for any new investment advisory clients for one year, required Gintel Asset Management and Gintel & Co. to mail a copy of the Commission order to all current clients, and required Gintel & Co. to provide a copy of the order to all prospective clients not less than 48 hours before executing any brokerage account opening documents.

3. **In the Matter of Back Bay Advisors, L.P.**, Advisers Act Release No. 25787 (Oct. 25, 2002). Enforcement alleged that Back Bay, formerly a registered investment adviser, engaged in prohibited affiliated transactions (cross trades) involving registered investment companies, made false statements or omissions to clients, altered records, and failed to reasonably supervise employees. Back Bay effected cross trades between an affiliated client and its investment companies and between investment companies without complying with an Investment Company Act Rule. Enforcement also alleged that Back Bay's personnel were ignorant of the applicable statutory requirements and followed their own procedures for cross trades. The Commission ordered Back Bay to pay a $150,000 penalty.

4. **In the Matter of Edgar M. Reed,** Investment Company Act Release No. 25786 (Oct. 25, 2002). *See* Section E.3., above. Reed was Back Bay's chief investment officer and a financial analyst. He supervised Back Bay's portfolio managers and traders, was responsible for ensuring that the investment staff executed trades, and managed portfolios in compliance with the securities laws. Enforcement alleged that after being informed that the Commission's staff intended to conduct a routine exam, Reed directed a trader to add information to the firm's complete cross trade tickets. The Commission censured Reed, ordered him to cease and desist from committing or causing future violations, suspended him from association with any investment adviser or registered investment company for 12 months, and ordered him to pay a $25,000 penalty.

5. **In the Matter of ND Money Management, Inc.; Ranson Capital Corporation; Robert E. Walstad; and Monte L. Avery,** Investment Company Act Release No. 25523 (Apr. 12, 2002). *See* Section C.3., above.

6. **In the Matter of Lawrence P. Grady**, Investment Company Act Release No. 25201 (Sept. 28, 2001). *See* Section C.4., above.

7. **In the Matter of Charles G. Dyer, Hawthorne Investment Trust, and Hawthorne Associates, Inc.,** Investment Company Act Release No. 25107 (Aug. 9, 2001). Enforcement alleged that a registered investment company failed to comply with the books and records, reporting, and governance requirements of the Investment Company Act. Dyer was the fund's sole officer and trustee. The fund renewed an investment advisory contract without the approval of a majority of the directors who were not interested persons. Further, the Hawthorne Associates and another adviser committed numerous books and records violations. The Commission: (1) ordered the fund, Hawthorne Associates, and Dyer to cease and desist from committing or causing future violations; (2) prohibited Dyer from associating with an investment company or an investment adviser for 12 months; and (3) ordered Dyer and Hawthorne

Associates to jointly pay a $25,000 penalty.

8. **<u>In the Matter of Nova Communications Ltd and Murray W. Goldenberg</u>**, Investment Company Act Release No. 24384 (Apr. 10, 2000). In this settled administrative proceeding, the Commission found that Nova Communications Ltd., formerly known as First Colonial Ventures Ltd. ("FVCL"), and its president and CEO, Goldenberg, engaged in a variety of unlawful conduct. FCVL engaged in four transactions in which FCVL acquired certain assets, leases, and interests. At the time that FCVL made these acquisitions, FCVL was operating as a business development company ("BDC"). The Investment Company Act prohibited FCVL, as a BDC, from acquiring any assets other than "BDC Qualifying Assets," unless at least 70% of FCVL's total assets were BDC Qualifying Assets. At the time that FCVL made each of the four acquisitions, less than 70% of FCVL's total assets were BDC Qualifying Assets. FCVL also issued over three million FCVL shares to Colonial Funds for no consideration, causing them to be listed at below NAV in contravention of the Investment Company Act. In addition, FCVL failed to maintain certain books and records regarding securities transactions. After becoming a BDC, FCVL offered and sold securities without including certain information in its offering circulars as required by Regulation E and failed to file certain documents with the Commission, including a registration statement, reports of its sales, and certain 10-Qs and 10-Ks. The Commission ordered the respondents to cease and desist from future violations.

9. **<u>In the Matter of Terence Michael Coxon, Alan Michael Sergy, World Money Managers and World Money Securities, Inc.</u>**, Advisers Act Release Nos. 2161 (Aug. 21, 2003) and 1857 (Mar. 2, 2002); Initial Decision No. 140 (Apr. 1, 1999); and Advisers Act Release No. 1604 (Jan. 13, 1997). *See* Section C.9., above.

10. **<u>In the Matter of Concord Growth Corporation</u>**, Investment Company Act Release No. 23470 (Sept. 28, 1998). The Commission instituted proceedings against Concord and certain individuals: Rutherford, the chairman, CEO, and 20% owner of Concord (in a related proceeding); Borgardt, a fund director and the fund's portfolio manager and president of the fund's investment adviser; and Banhazl, secretary and treasurer of the fund and portfolio manager of the fund. The Commission alleged that Concord, a commercial finance company that makes asset-backed loans to businesses, acting as principal, sold loan participations to a fund while it was an affiliate of an affiliate of the fund. No prior approval to engage in these transactions was sought or received from the Commission. The fund's entire portfolio consisted of loan participations purchased from, and originated and serviced by, Concord.

11. **<u>In the Matter of Reid Rutherford</u>**, Investment Company Act Release No. 23469 (Sept. 28, 1998). *See* Section E.10., above. The Commission ordered Rutherford to cease and desist from committing future violations, and pay a $5,000 penalty.

12. **<u>In the Matter of Byron G. Borgardt and Eric M. Banhazl</u>**, Investment Company Act Release No. 26169 (Aug. 25, 2003). *See* Section E.10., above. The Commission ordered Borgardt and Banhazl to cease and desist from committing future violations.

13. **<u>In the Matter of Nicholas P. Howard</u>**, Initial Decision No. 138 (Mar. 24, 1999), Exchange Act Release No. 47357 (Feb. 12, 2003). Howard was a senior vice president in charge

of marketing at James Capel, Inc. (JCI). JCI was an investment adviser to the European Warrant Fund (EWF), a registered closed-end investment company. Howard, who had participated in the development of the EWF, received an indication of interest for securities being offered by JCI from Julius Baer Securities, Inc. on behalf of EWF. Howard was unable to reach the individual who had sent the indication of interest on behalf of EWF before the close of the subscription period to confirm EWF's order. JCI's president told Howard that JCI would purchase the shares and that Howard should contact Baer later. JCI purchased the shares. Howard later confirmed the order with Baer, and the shares were sold by JCI to the EWF. The shares were counted towards a 2,000,000 share offering minimum that was part of the transaction. Neither JCI nor Howard disclosed these circumstances to investors. The Commission suspended Howard from associating with a broker or dealer for three months, ordered him to cease and desist from future violations, and ordered him to pay a civil penalty of $50,000.

F. IPO Related

1. In the Matter of Nevis Capital Management, LLC; David. R. Wilmerding; III; and Jon C. Baker, Investment Company Act Release No. 26144 (July 31, 2003) and Investment Advisers Act Release No. 2214 (Feb. 9, 2004). In this administrative proceeding, Enforcement alleged that Nevis Capital Management, LLC ("Nevis), a registered investment adviser, disproportionately allocated IPOs to a registered investment company it advised, which at the time was a small start-up fund, and a hedge fund that paid a performance fee. Nevis failed to disclose the large impact the IPOs had on the unusually superior performance of the fund. Nevis allocated a large portion of IPOs it received to the fund and hedge fund at the expense of other clients. Nevis' Form ADV and brochure claimed that all clients would be treated equally ("on a pro-rata basis") and that interests of clients not related to Nevis would be given priority. The staff alleges that preferential IPO allocations enabled the fund to achieve outstanding performance between December 1998 and December 1999. The exceptional performance of the fund was accompanied by a tremendous asset growth. Further, Enforcement *alleged* that Nevis, Wilmerding and Baker made false and misleading statements and omitted material information in the fund's prospectus, annual and semi-annual reports, and advertisements by failing to disclose that the fund's performance was primarily attributable to IPOs, stating instead that the fund had invested only in a couple IPOs. The respondents ultimately settled the matter by agreeing to undertake appropriate review of its procedures, provide a copy of the Commission's order to current and prospective clients, and pay $2 million in disgorgement and penalties, which the Commission contemplates will be returned to defrauded shareholders through a Fair Fund distribution.

2. In the Matter of Davis Selected Advisers-NY, Inc., Investment Company Act Release No. 25727 (Sept. 4, 2002). Enforcement alleged that Davis Selected Advisers-NY, Inc. (a sub-adviser to a registered investment company), violated the Investment Company Act by failing to disclose that the fund's performance was significantly impacted by IPO trading. Specifically, an Investment Company Act form requires that a fund describe factors that materially affected fund performance in its last fiscal year. In 1999, the fund's total return was 31.4% and IPO trading accounted for over 25% of that return. In 2000, IPO trading accounted for over one half of the fund's total return of 11.5%. Neither the prospectus nor the fund's annual reports mentioned IPO trading. The Commission ordered the respondent to cease and

desist from committing or causing future violations and to pay a $10,000 penalty.

3. **In the Matter of the Dreyfus Corporation and Michael L. Schonberg**, Investment Company Act Release No. 24450 (May 10, 2000). The Dreyfus Corporation ("Dreyfus") served as the investment adviser for the Dreyfus Aggressive Growth Fund ("DAG") and other investment companies ("Dreyfus Funds"). Schonberg served as portfolio manager for five of the Dreyfus Funds, including DAG. Enforcement alleged that over the course of DAG's first fiscal year, Schonberg's allocations of securities purchased in IPOs favored DAG over three other funds Schonberg managed. Neither Dreyfus nor Schonberg disclosed this practice, notwithstanding DAG's prospectus disclosure that investment opportunities would be allocated equitably among Dreyfus Funds. Dreyfus also did not review Schonberg's IPO allocations. DAG achieved exceptional returns during its first fiscal year in large part because of the investments in IPOs. Dreyfus did not disclose the large impact of the IPO investments, though it was questionable whether DAG could replicate its prior performance through continuing to invest in IPOs as the fund grew larger. In addition, Enforcement alleged that although Dreyfus had a written code of ethics, it had not instituted adequate procedures reasonably necessary to prevent violations of its code of ethics relating to potential conflicts of interest. The Commission ordered the following: (1) a censure of Dreyfus and Schonberg; (2) Dreyfus and Schonberg to cease and desist from committing or causing any future violation; (3) Dreyfus and Schonberg to pay penalties of $950,000 and $50,000, respectively; (4) Schonberg to be suspended from association with any investment adviser or investment company for nine months; and (5) Dreyfus to hire an independent consultant.

4. **In the Matter of Van Kampen Advisory Corp. and Alan Sachtleben**, Advisers Act Release No. 1819 (Sept. 8, 1999). Enforcement alleged that Van Kampen Advisory, a registered investment adviser, made disclosures in its sales literature and public filings that touted the performance of its Van Kampen Growth Fund (now known as Van Kampen Equity Trust) without disclosing the large impact that hot IPOs had on the fund's return. It instead attributed the performance to investment in technology, financial services and health care sectors. Sachtleben was Van Kampen Advisory's chief investment officer and had control over the advertisements for the fund and the public filings. The Commission censured Van Kampen Advisory and Sachtleben, and ordered them to cease and desist from future violations. Van Kampen Advisory and Sachtleben were ordered to pay civil penalties of $100,000 and $25,000, respectively.

5. **In the Matter of Monetta Financial Services, Inc.**, Advisers Act Release Nos. 2136 (June 9, 2003) and 1702 (Feb. 26, 1998); and Initial Decision Release No. 162 (Mar. 27, 2000). Enforcement alleged that the president of an investment adviser allocated hot IPOs to fund directors (two inside director, "Valiant" and "Henry," and one independent director, "Russo") where the funds also were eligible and able to invest in the IPOs. The president of the investment adviser ("Bacarella") did not disclose the allocation practice or the material conflict of interest raised by the practice. The directors accepted the trades without disclosing the arrangement to fund shareholders and without getting approval of a disinterested representative of the fund. Among other things, the Commission ordered: (a) Monetta Financial Services and Robert Bacarella to cease and desist from committing or causing any future violations; (b) Bacarella be suspended from associating with an investment adviser for a period of 90 days; (c)

MFS pay a penalty of $200,000; and (d) Bacarella pay a penalty of $100,000.

G. Misconduct with Respect to Non-Fund Clients

1. SEC v. Nathan Chapman, Jr., Litigation Release No. 18203 (June 26, 2003). The Commission filed a civil injunctive action against Chapman, three of his companies and three of his associates in connection with the June 2000 IPO of, and subsequent secondary market trading in, the common stock of eChapman.com, Inc. ("ECMN"). The complaint alleged that, in an effort to rescue a failing IPO, Chapman and others engaged in fraudulent conduct, including: backdating trades and placing close to one-third of the IPO shares into the account of an advisory client, unauthorized sales of ECMN stock to customers of a broker-dealer controlled by Chapman; manipulating the market for ECMN stock for months following the IPO, and filing false and misleading reports with the Commission. As a result of the fraudulent conduct, investors lost millions of dollars. Finally, the complaint alleged that Chapman and others manipulated the market for ECMN by using IPO proceeds to buy hundreds of thousands of ECMN shares in the months following the offering, and discouraged advisory clients and brokerage customers from selling their ECMN stock.

2. In the Matter of Frederick A. Wolf, Investment Advisers Act Release No. 1933 (Mar. 20, 2001). The Commission found that shortly after Valley Forge Capital Holdings ("VFCH") purchased Barrington, a registered investment adviser, Wolf, the President of Barrington, began promoting VFCH securities to its advisory clients. Between January 1994 and July 1996, Barrington clients purchased $2.2 million in VFCH securities. Wolf was responsible for all of these purchases, either by recommending VFCH to his clients or by using his discretionary trading authority in certain client accounts to effectuate the purchases. In at least two cases, Wolf used his discretionary authority to purchase VFCH securities even though such high-risk investments were contrary to his clients' stated investment objectives. In other cases, Wolf recommended that clients purchase VFCH securities without disclosing the high-risk nature of the securities. In addition, beginning in July 1994 Barrington and Wolf were aware of red flags concerning the integrity of VFCH management and the truthfulness of its representations as to how it would use the offering proceeds. The Commission's order provided that Wolf cease and desist from future violations and that he be suspended from association with any investment adviser for a period of 12 months.

H. Market Manipulation

In the Matter of Baron Capital, Inc.; Ronald S. Baron; David Schneider; and Susan Blenke, Exchange Act Release No. 47751 (Apr. 29, 2003). Enforcement alleged that the CEO ("Baron") of a registered investment adviser ("Baron Capital") instructed two Baron Capital traders ("Schneider" and "Blenke") to manipulate the closing prices of stock of Southern Union Company ("SUG"). In June 1999, SUG and another company announced the terms of a planned merger, which depended on the average closing price of SUG's stock during a two-week pricing period. During the two-week pricing period, Baron Capital made large purchases of SUG during the final hour of trading each trading day, constituting 78% of the trading volume. The Commission ordered: (a) Baron Capital, Baron, Schneider, and Blenke to cease and desist from committing or causing any future violations; (b) Baron Capital, Baron, Schneider, and Blenke to

be censured; (c) Baron Capital to pay a $2 million penalty; (d) Baron to pay a $500,000 penalty; (e) Schneider to pay a $125,000 penalty; and (f) Blenke to pay a $75,000 penalty. Baron Capital agreed to implement new procedures and hire a new compliance officer.

I. Mispricing of Fund Shares

1. **SEC v. Rupay-Barrington Capital Management, Inc., Litigation Release No. 17345 (Jan. 29, 2002).** The Commission alleged that an adviser ("Rupay Management") caused an advisory client (a registered investment company) to carry a worthless receivable from the holding company for Rupay Barrington ("Rupay Group") when the Rupay Group was deeply insolvent. The Commission alleged that even though the receivable was uncollectible, Rupay Management caused the fund's books to reflect the receivable at full face value. The shareholders were not told of the worthless receivable and that Rupay Management advised its private advisory clients to invest in the fund. The Commission also alleged that the fund's shareholder report misrepresented that Rupay Group was paying on the receivable, when it was not. The defendants consented to the entry of a preliminary injunction and an order appointing a Special Master to assume management of the fund and to liquidate the fund.

2. **In the Matter of Judy M. Rupay and Dixon R. Holman,** Advisers Act Release No. 2113 (Mar. 4, 2003). *See* Section I.1., above. Judy Rupay was an indirect shareholder and director of Rupay Management and the president and CEO of the Rupay Group. Holman was a director and president of Rupay Management, the vice president and chief operating officer of the Group, and a vice president of the fund. The Commission found that Judy Rupay and Holman willfully aided and abetted and caused Rupay Management's violations. The Commission: (a) ordered Judy Rupay and Holman to cease and desist from committing or causing future violations; (b) prohibited Judy Rupay and Holman from associating with a registered investment company for six months; and (c) ordered Judy Rupay and Holman each to pay a $10,000 penalty.

3. **SEC v. Heartland Group, Inc.,** Litigation Release No. 17247 (Nov. 27, 2001). The Commission alleged that Heartland Group, a registered investment company with multiple series, failed to send an annual report to shareholders of three funds and failed to timely file the report with the Commission. The Commission further alleged that this failure was due to the Heartland Group's inability to obtain audited financial results for the three funds for fiscal year 2000, due to Heartland Group's independent public accountant's concerns regarding the underlying valuations of the securities held in the funds. The Commission obtained a permanent injunction enjoining Heartland Group from further violations. The court order also froze the assets held in the three funds and provided for the appointment of a receiver to take control of the assets, manage the funds, suspend redemptions in the funds, and, if appropriate, liquidate the funds.

4. **In the Matter of Western Asset Management Co. and Legg Mason Fund Adviser,** Investment Advisers Act Release No. 1980 (Sept. 28, 2001). The Commission found that a portfolio manager, Trudie D. Whitehead, had defrauded a mutual fund and an offshore fund from 1996 to 1998. Whitehead concealed from the funds and their investment advisers that issuers of securities held by the funds were suffering severe financial problems and inflated the

value of the troubled securities, which caused one of the funds materially to overstate its NAV. The Commission found that the funds' manager, Legg Mason Fund Adviser ("LM Fund Adviser") and its sub-adviser, Western Asset Management ("WAM") failed to have adequate policies and procedures to respond adequately to indications that the portfolio manager was overstating the value of one of the fund's securities. LMFA and WAM were each ordered to pay a civil penalty of $50,000 and to comply with undertakings to maintain enhanced supervisory policies and procedures previously implemented. Whitehead was ordered: (a) to cease and desist from committing future violations; (b) to pay a civil penalty of $25,000; and (c) to be barred from associating with an investment adviser or an investment company. Kyle R. Kirkland, a registered representative who assisted Whitehead in this scheme, was ordered (a) to cease and desist from future violations; (b) to pay a civil penalty of $30,000; and (c) to be barred from association with any broker-dealer or investment company with a right to reapply for association after three years.

5. **In the Matter of Trudie D. Whitehead**, Investment Company Act Release No. 25198 (Sept. 28, 2001). *See* Section I.4., above.

6. **In the Matter of Kyle R. Kirkland**, Investment Company Act Release No. 25199 (Sept. 28, 2001). *See* Section I.4., above.

7. **In the Matter of John Wellington Bagwell**, Investment Company Act Release No. 24934 (Apr. 10, 2001). The Commission found that Bagwell was registered with the Commission as an investment adviser and conducted his advisory business as a sole proprietor. Bagwell also managed a registered investment company, the JWB Aggressive Growth Fund. The fund's registration statements represented that Bagwell agreed to reimburse the fund for certain operating expenses above the fund's expense cap. Bagwell regularly paid or reimbursed the fund for expenses until the end of April 1997. By early November 1997, the receivable was about 9% of the fund's net assets. In November 1997, Bagwell reduced the receivable with funds borrowed from one of the fund's shareholders. Previously, he had represented to the fund's trustees that he would reduce the receivable with personal funds. The receivable, however, continued to increase and by the end of September 1998, it reached about 18% of the fund's net assets. The fund accountant informed Bagwell that if the receivable was not paid, the fund's NAV should be reduced. Bagwell instructed the accountant not to adjust the fund's NAV and assured the fund's trustees that he could and would pay off the receivable. Bagwell proposed to the trustees a schedule to pay off the receivable by making monthly payments and he also provided the trustees with a financial statement that misrepresented his financial condition. By the end of 1998, the receivable reached 25% of the fund's NAV. In April 1999, Bagwell liquidated the fund. The Commission (a) barred Bagwell from association with any investment adviser or investment company; (b) ordered Bagwell to cease and desist from committing or causing any future violations; and (c) ordered Bagwell pay to pay a civil penalty of $10,000.

8. **In the Matter of Harry Michael Schwartz,** Investment Company Act 24053 (Sept. 27, 1999). The Commission found that Schwartz was the president and chief financial officer of a registered investment adviser and a director and officer of a registered investment company. The trustees of the fund approved an expense reimbursement agreement, which provided that the adviser would reimburse the fund for certain expenses that exceeded a specified

limitation. The agreement also provided for a one-time capital contribution in the amount of $228,000 by the adviser to the fund to reimburse the fund for past expenses that exceeded a specified limitation. The Commission found that the adviser failed to disclose its poor financial condition or the fact that it had no available funds or commitments to meet its financial obligations to the fund. The adviser delayed making the capital contribution for approximately five months and was made only after a third party loaned money to the adviser for the payment. The adviser had agreed to reimburse the fund by a specific date but defaulted on the payment for nearly six weeks. The payment was made to the fund after Schwartz and third parties raised the money for the payment. A semi-annual report filed with the Commission disclosed the reimbursement agreement but failed to the terms of the agreement. The Commission: (a) ordered Schwartz to cease and desist from committing or causing any future violations; (b) suspended Schwartz from associating with any investment adviser or investment company for 12 months; and (c) order Schwartz to pay a penalty of 10,000.

9. **<u>In the Matter of Ellen Griggs</u>**, Advisers Act Release Nos. 1836 (Sept. 27, 1999) and 1750 (Sept. 14, 1998). *See also* **<u>In the Matter of Mitchell Hutchins Asset Management</u>**, Advisers Act Release No. 1654; Investment Company Act Release No. 22805 (Sept. 2, 1997) *See* Section C.14., above. The Commission found that Griggs, Stephen H. Brown's supervisor, failed reasonably to supervise Brown with a view to preventing his violations of the federal securities laws. Brown had invested PaineWebber Short-Term U.S. Government Income Fund assets in securities that exposed investors to significantly higher levels of risk than had been disclosed in the fund's offering materials. His improper conduct remained undetected by Mitchell Hutchins until late April 1994 because Griggs failed to review his purchases of securities for the fund's portfolio. Griggs was suspended from association with any investment adviser for one month and from acting in any supervisory capacity with any investment adviser for a period of four months immediately following her suspension from association, and was ordered to pay a civil monetary penalty of $10,000.

10. **<u>SEC v. Michael Carnicle, Michael Hansen, William Straughan, Randy Glad, Lionel Reifler, Howard Ray, and Arie From</u>**, Litigation Release No. 16293 (Sept. 27, 1999). *See* Section C.5., above.

11. **<u>In the Matter of James Thomas McCurdy</u>**, Initial Decision Release No. 213 (Aug. 13, 2002); Accounting and Auditing Enforcement Release No. 1404 (June 14, 2001). *See* Section I.7., above. Enforcement alleged that McCurdy, an Ohio certified public accountant ("CPA"), failed to comply with professional auditing standards by failing to obtain sufficient competent evidence of a receivable from a related party in connection with the audit of JWB Aggressive Growth Fund. The ALJ dismissed the proceedings upon finding that McCurdy did not engage in improper conduct with the meaning of Rule 102 of the Commission's Rules of Practice.

12. **<u>In the Matter of Parnassus Investments</u>**, Initial Decision Release No. 131 (Sept. 3, 1998); and Advisers Act Release No. 1634 (May 28, 1997). The ALJ found that a mutual fund's directors and its investment adviser caused the fund to value a portfolio security at a value higher than its fair value. The ALJ found that for over two years, the directors valued the portfolio security at $0.344/share (the last available NASDAQ quote), despite the fact that the

security was being traded at prices as low as $0.01/share during the period. The ALJ ordered respondents to cease and desist any such violation or future violation.

13. **In the Matter of The Rockies Fund, Inc.; Stephen G. Calandrella; Charles M. Powell; Clifford C. Thygesen; and John C. Power**, Investment Company Act Release No. 26202 (Oct. 2, 2003); Initial Decision Release No. 181 (Mar. 9, 2001); and Investment Company Act Release No. 23229 (June 2, 1998). *See* Section C.7., above.

14. **In the Matter of Piper Capital Management, Inc.; Worth V. Bruntjen; Marijo A. Goldstein; Robert H. Nelson; Amy K. Johnson; Molly Destro; and Edward J. Kohler,** Advisers Act Release No. 2163 (Aug. 26, 2003); Initial Decision Release No. 175 (Nov. 30, 2000)**; In the Matter of Worth V. Bruntjen**, Investment Company Act Release No. 23664 (Jan. 26, 1999); and Advisers Act Release No. 1737 (July 28, 1998). Enforcement alleged that each of the respondents, except Kohler, committed fraud in connection with calculating the fund's NAV. According to the order, the fund's prospectus falsely stated that Piper Capital Management ("PCM") would calculate current NAV on a daily basis for purchases and redemptions of fund shares. Enforcement alleged that, in fact, a majority of the securities in the fund's portfolio were priced only on a weekly basis and that PCM and Bruntjen and Goldstein, the portfolio managers, knew or were reckless in not knowing of the weekly pricing. Enforcement further alleged that the respondents engaged in or were aware of a scheme to override dealer quotations and to gradually lower or "ratchet down" prices of securities in the fund's portfolio to limit declines in the fund's NAV. The Commission upheld the ALJ's findings and (a) revoked PCM's registration; (b) ordered PCM to pay a penalty of $2,005,000; (c) censured the individual defendants (Goldstein, Nelson, Johnson, and Destro); and (d) ordered them to cease and desist from committing or causing any future violations.

15. **In the Matter of Carol A. Wallace**, Exchange Act Release No. 48372 (Aug. 20, 2003); Initial Decision No. 178 (Dec. 18, 2000); and Exchange Act Release No. 41240 (Apr. 1, 1999). *See* Section C.7., above. Wallace was a CPA and auditor for the Rockies Fund.

16. **In the Matter of John E. Backlund, John H. Hankins, Howard L. Peterson, and John G. Guffey**, Investment Company Act Release No. 23639 (Jan. 11, 1999); and **In the Matter of Craig S. Vanucci and Brian K. Andrew**, Advisers Act Release No. 1782 (Jan. 11, 1999). In two related cases, the Commission instituted and simultaneously settled two proceedings involving a money market fund that "broke the dollar" (*i.e.*, failed to maintain a $1.00 per share NAV) and liquidated in September 1994 at $.96 per share. The Commission found that the fund's two portfolio managers invested 27% of the fund's assets in adjustable-rate derivatives, known as structured notes, an amount that the Commission found unsuitable for a money market fund. The Commission also found that the fund's directors knew at least by June 1994 that the fund had made a substantial investment in the derivatives and that the derivatives were plummeting in value in response to a sharp increase in short-term interest rates, which had a material, negative effect on the fund's NAV. They nonetheless continued to permit fund shares to be sold and redeemed at $1.00 per share and continued to permit the fund's portfolio securities to be valued using the amortized cost method without any reasonable expectation that the value of the derivatives would return to par or that they could be liquidated at their carrying value in the near future. The Commission ordered the directors to cease and desist from committing or

causing future violations. In addition, John E. Backlund ("Backlund"), the president and a director of the fund, was ordered to pay a $10,000 civil penalty; and John H. Hankins, Howard L. Peterson, and John G. Guffey, also fund directors, were each ordered to pay a $5,000 civil penalty. Finally, Backlund was suspended from association with any investment company or investment adviser for 12 months. The Commission ordered the two portfolio managers to cease and desist from committing or causing future violations and to pay a $30,000 civil penalty.

17. SEC v. Heartland Advisors, Inc., Litigation Release No. 171 (Dec. 11 2003); **In the Matter of FT Interactive Data, f/k/a Interactive Data Corporation**, Investment Advisers Act Release No. 2201 (Dec. 11 2003); **In the Matter of Jon D. Hammes**, Investment Company Act Release No. 26290 (Dec. 11, 2003). See I.3., above. The Commission alleged that Heatland Advisors, an investment adviser to a complex of mutual funds, its CEO, two portfolio managers, four officers, and five directors mispriced the shares of the funds and/or committed insider trading. The value of the funds, and a smaller related fund, dropped by approximately $93 million during a two-week period in 2000 when Heartland Advisors sought to correct months of deliberate mispricing. Furthermore, certain of the insiders sold their shares, or tipped others to sell their shares, while aware that the funds had liquidity and pricing problems. The matter is litigating. In the first related administrative proceeding, the Commission found that FT Interactive Data, a securities pricing service, aided and abetted and caused certain of the violations. The pricing service settled the proceeding by being ordered to cease and desist from violations, pay a $125,000 fine, and undertake remedial action. In the second related administrative proceeding, the Commission found that four independent directors of the mutual funds negligently failed to adequately monitor the liquidity of the funds, and failed to take adequate steps to address the funds' pricing deficiencies. The Commission ordered the directors to cease and desist committing or causing future violations.

J. Advertising

1. In the Matter of The Thurlow Funds; Thurlow Capital Management, Inc.; and Thomas F. Thurlow, Investment Company Act Release No. 25761 (Oct. 2, 2002). The Commission instituted and settled proceedings that involved outdated performance returns on an Internet website advertising the Thurlow Growth Fund, a mutual fund offered by the Thurlow Funds, Inc., a registered investment company. As late as December 2000, the website prominently proclaimed returns for the Thurlow Growth Fund of 422% from inception through March 10, 2000. This information, while factually accurate, was rendered misleading by Thurlow's failure to disclose that the fund's total returns had declined by more than half between March 10, 2000 and September 30, 2000, the most recent quarter. The website emphasized the Thurlow Growth Fund's performance through March 10, 2000, essentially the time at which its performance had peaked, while failing to adequately disclose the decline over the subsequent two quarters. The Commission censured Thurlow Capital Management and Thomas F. Thurlow and ordered them to cease and desist from committing or causing any future violations. The Commission also ordered Thomas F. Thurlow to pay a civil money penalty of $20,000 and to comply with undertakings to confirm the information about stocks on Thurlow Capital Management's website.

2. **In the Matter of Merrimac Advisors Company**, Advisers Act Release Nos. 2009 (Jan. 4, 2002) and 1977 (Sept. 27, 2001). Enforcement alleged that, from 1997 through 1998, Fredric J. French, the principal of Merrimac Advisors Company, a registered investment adviser, provided clients and potential clients false information claiming that Merrimac had a five-year performance history of generating annual returns over 20%, and also overstating the number of Merrimac's clients and amount of client funds under management. The ALJ imposed a default judgment and the following sanctions: French and Merrimac were censured and ordered to cease and desist from committing or causing any future violations; the registration of Merrimac was revoked; French was ordered to be barred from association with any investment adviser and prohibited from serving or acting as an employee, officer, director, member of an advisory board, investment adviser or depositor of, or principal underwriter for, a registered investment company or affiliated person of such investment adviser, depositor, or principal underwriter; and ordered French and Merrimac each to pay a civil penalty of $50,000.

3. **In the Matter of Fundamental Portfolio Advisors, Inc.; Lance M. Brofman; Vincent J. Malanga; and Fundamental Service Corporation**, Advisers Act Release No. (July 15, 2003); Initial Decision Release No. 180 (Jan. 29, 2001); and Exchange Act Release No. 39158 (Sept. 30, 1997). *See* Section C.10., above.

4. **In the Matter of Javed Anver Latef and Larry Alan Stockett**, Advisers Act Release No. 2116 (Mar. 20, 2003); **and In the Matter of Hudson Investor Funds, Inc.; Hudson Advisers, Inc.; Javed Anver Latef; and Larry Alan Stockett**, Initial Decision No. 139 (Mar. 30, 1999). *See* Section C.12., above.

K. Soft Dollars

1. **In the Matter of Duff & Phelps Investment Management Co., Inc.,** Investment Company Act Release No. 25200 (Sept. 28, 2001). Enforcement alleged that Duff & Phelps Management Co., a registered investment adviser, obtained the pension fund of the International Brotherhood of Teamsters Union Local 710 ("Local 710") as a client after agreeing to direct brokerage trades to broker-dealer East West Institutional Services ("East West"). Enforcement alleged that East West had entered into an arrangement with two trustees of the Local 710 in which East West agreed to kick back to the two trustees a portion of the commissions directed to it by the Local 710's investment advisers. In addition to the East West arrangement, Duff negotiated a soft dollar agreement with the Pension Consultant. Under this agreement, Duff agreed to pay an annual fee with soft dollars to the Pension Consultant by directing commission business to the Pension Consultant's affiliated broker-dealer in exchange for a recommendation from the Pension Consultant that the Local 710 retain Duff as an investment adviser. Duff never disclosed any of the arrangements to disinterested representatives of the Local 710 or its other clients, including registered investment companies. The Commission (a) ordered Duff to cease and desist from committing or causing any future violations; (b) censured Duff; (c) ordered Duff to pay a civil penalty of $100,000; and (d) ordered Duff to pay disgorgement of $613,000 to the appropriate clients, as well as refunds of an additional $141,161 in commissions and pre-judgment interest to clients affected by soft-dollar arrangement between Duff and the Pension Consultant. The Commission found that Stevens, Duff's president and CEO, willfully aided and abetted Duff's violations and Commission ordered Stevens to (a) cease and desist from

committing or causing any violations or future violations and (b) pay a civil penalty of $20,000.

2. **In the Matter of Clarke T. Blizzard and Rudolph Abel**, Initial Decision No. 229 (June 12, 2003) and Advisers Act Release No. 2032 (Apr. 23, 2002); and **In the Matter of Clarke T. Blizzard,** Advisers Act Release No. 2030 (April 23, 2002); **In the Matter of Fleet Investment Advisors, Inc.,** Advisers Act Release No. 1821 (Sept. 9, 1999); **In the Matter of Karen Michalski and Christopher D. Sargent**, Advisers Act Release No. 1822 (Sept. 9, 1999); **In the Matter of Michael J. Rothmeier, Clarke T. Blizzard, Rudolph Abel, Donald C. Berry, Christopher P. Roach, Craig Janutol, and East West Institutional Services, Inc.,** Advisers Act Release No. 2016 (Feb. 28, 2002); Advisers Act Release No. 1823 (Sept. 9, 1999); and Advisers Act Release Nos. 1865, 1866, 1867 (Apr. 13, 2000). The Commission instituted administrative and cease and desist proceedings against Fleet Investment Advisors (successor to Shawmut Investment Advisers, Inc.). In related actions, the Commission instituted proceedings against certain of Fleet's employees and a broker-dealer for aiding and abetting various of Fleet's violations. The Commission found that Fleet had engaged in an undisclosed soft dollar arrangement by directing client brokerage to brokers in exchange for client referrals. The Commission also found that Fleet failed to seek best execution for clients and failed to maintain appropriate records. The Commission ordered Fleet to cease and desist from future violations and to disgorgement of more than $1.9 million. In a separate action, two traders were charged with aiding and abetting Fleet's violations and consented to a cease-and-desist order, a civil penalty of $5,000 each, and to be barred from association with an investment adviser with a right to reapply in 15 months.

Michael Rothmeier, Donald Berry, and Craig Janutol settled administrative proceedings in connection with Shawmut Advisers' fraudulent use of $1.8 million in equity and fixed income commission to pay broker-dealers for client referrals. Shawmut's ADV stated that it selected broker-dealers on the basis of research services. However, Shawmut directed brokerage to broker-dealers based on ability to refer clients. Rothmeier and Berry were ordered to cease and desist from certain violations of the Advisers Act. Rothmeier received a nine-month suspension from association with an investment adviser and was fined $15,000. Berry received a six-month suspension from association with an investment adviser and was fined $5,000. Janutol was suspended from association with any broker-dealer for six months and suspended from association in a supervisory and propriety capacity with any broker-dealer for 12 months. In addition, he was fined $5,000.

In a default order, the Commission (a) ordered Roach and East-West to cease and desist from committing or causing future violations; (b) barred Roach from association with any broker or dealer; (c) censured East-West; (d) revoked East-West's registration as a broker or dealer; (e) ordered Roach to disgorge $950,000 plus prejudgment interest; (f) ordered Roach to pay a civil penalty of $100,000; and (g) ordered East-West to pay a civil penalty of $500,000.

The ALJ dismissed the proceedings with respect to Abel and ordered Blizzard to: (a) be suspended from association with an investment adviser for 90 days; (b) pay a civil penalty of $100,000; (c) disgorge $548,233 plus prejudgment interest; and (d) cease and desist from committing or causing any violations or future violations.

L. Violation of Bar Orders

1. **In the Matter of Harry Michael Schwartz**, Investment Company Act 24053 (Sept. 27, 1999). *See* Section I.8., above.

2. **Securities and Exchange Commission v. Charles F. Parisi**, Litigation Release No. 16295 (Sept. 27, 1999). *See* Section L.1., above. Schwartz was Parisi's long-time employee.

M. Abusive Practices in the Sale of Investment Companies

1. **In the Matter of Morgan Stanley DW, Inc.,** Securities Act of 1933 (hereinafter cited as "Securities Act") Release No. 8339 (Nov. 17, 2003). The Commission found that Morgan Stanley, a registered broker-dealer, had a "Partners Program" in which select mutual funds paid Morgan Stanley substantial fees for preferred marketing of their funds. The Commission found that Morgan Stanley paid increased compensation to individual registered representatives and branch managers on sales of those funds' shares. The fund complexes paid the fees in cash or in the form of portfolio brokerage. In addition, Morgan Stanley failed to adequately disclose the point of sale the higher fees associated with large ($100,000 or greater) purchases of Class B shares of certain of its proprietary mutual funds could be reduced by purchase of Class A shares. The Commission also found that Morgan Stanley failed to disclose that the higher fees associated with the Class B shares could have a negative impact on customers' investment returns. The Commission censured Morgan Stanley and ordered it to (a) cease and desist from committing or causing an violations and any future violations; (b) to disgorgement plus prejudgment interest of $25 million and a civil penalty of $25 million; and (c) comply with certain undertakings including the hiring of a special consultant.

2. **SEC v. Gregory P. Waldon**, Exchange Act Release 48419 (Aug. 29, 2003); and Litigation Release No. 17591 (June 27, 2002); and **In the Matter of Donna N. Morehead,** Exchange Act Release No. 46121 (June 26, 2002). The Commission alleged that Waldon, a registered representative, engaged in switching transactions involving variable annuities. To induce customers to switch, Waldon made various misrepresentations and failed to disclose information concerning the costs and risks of switching. The Commission found that Waldon's supervisor, Morehead, failed to reasonably supervise Waldon. The Commission found that Morehead failed to reasonably supervise Waldon and ordered her to pay a $10,000 penalty and to be barred from association in a supervisory capacity with any broker or dealer for one year. Waldon was enjoined from future violations and, in a follow-on proceeding, the Commission barred Waldon from association with any broker-dealer with the right to reapply after three years.

3. **In the Matter of Michael Flanagan, Ronald Kindschi, and Spectrum Administration, Inc.,** Advisers Act Release No. 2152 (July 30, 2003) and Initial Decision Release No. 160 (Jan. 31, 2000)**; In the Matter of FSC Securities Corporation**, Exchange Act Release No. 40765 (Dec. 9, 1998); **In the Matter of Michael Flanagan; Ronald Kindschi; and Spectrum Administration, Inc.,** Advisers Act Release No. 1776 (Dec. 9, 1998); **In the Matter of Richard Hoffman and Kirk Montgomery,** Exchange Act Release No. 40766 (Dec. 9, 1998);

and **In the Matter of Richard Hoffman and Kirk Montgomery,** Initial Decision Release No. 158 (Jan. 27, 2000). In related actions, the Commission instituted proceedings against registered representatives of FSC Securities Corporation ("FSC"), a registered broker dealer; Montgomery, FSC's chief compliance officer; Hoffman, a registered representative of FSC; Spectrum Administration, Inc. ("Spectrum"), a registered investment adviser; and Kindschi, Spectrum's associated person. Hoffman and Kindschi were independent contractors for two separate branch offices of FSC. In addition, Kindschi was associated with Spectrum. Flanagan was a registered representative employed by Kindschi. Enforcement alleged that Kindschi, Spectrum, and Flanagan engaged in breakpoint violations and that Flanagan engaged in breakpoint violations and mutual fund switching. Enforcement also alleged that Hoffman engaged in breakpoint violations and mutual fund switching. Enforcement further alleged that FSC and Montgomery failed reasonably to supervise a registered representative.

In a settled order, the Commission found that FSC had failed reasonably to supervise a registered representative, censured FSC, imposed a $50,000 fine, and accepted FSC's undertakings to retain an independent consultant to help FSC implement improved compliance procedures. An ALJ dismissed the charges against Hoffman and Montgomery. On appeal, the Commission found that the evidence did not support a finding of liability against Spectrum, Flanagan, and Kindschi on the charges and dismissed the proceeding.

4. **In the Matter of the Application of Wendell D. Belden**, Exchange Act Release No. 47859 (May 14, 2003). The NASD found that Belden, an investment company principal, had violated NASD rules by making unsuitable recommendations to a customer. Belden invested his customer's money (totaling more than one million dollars) in Class B mutual funds, which were subject to certain fees and charges. If Belton had invested the customer's money in Class A funds, the customer would not be charged a sales fee because his total investment was over one million dollars. Belden received a commission of $52,000; if he had invested his customer's money in Class A funds, Belden's commission would have been $16,000. In addition, the customer would not have incurred a contingent deferred sales charge when he exchanged his shares. The NASD suspended Belden for one year, fined him $40,000, ordered him to pay restitution of $55,567.03, and ordered that he requalify as a principal by examination. The Commission upheld the NASD's sanctions.

5. **In the Matter of Sandra Simpson and Daphne Pattee**, Exchange Act Release No. 45923 (May 14, 2002) and Initial Decision Release No. 148 (Sept. 21, 1999). Enforcement alleged that Simpson and Pattee, associated persons of Prudential Securities, Inc., defrauded customers by engaging in abusive mutual fund sales practices, including unauthorized transactions, unauthorized use of margins, unsuitable and excessive trading, and churning. Though Pattee was Simpson's sales assistant, the Commission found that they acted in concert to defraud their customers. Among other things, Simpson and Pattee identified "easy targets" by executing an unauthorized trade in account and waiting to see if the customer complained. If the customer failed to complain, they had identified an easy target. The Commission's order barred Simpson and Pattee from the broker-dealer industry; ordered that they cease and desist from committing or causing fraud violations; ordered them to pay, jointly and severally, $34,000 in disgorgement; and ordered Simpson and Pattee to pay penalties of $100,000 and $50,000, respectively.

6. **In the Matter of Norwest Investment Services, Inc. (now known as Wells Fargo Brokerage Services, LLC, successor by merger)**, Exchange Act Release No. 45460 (Feb. 20, 2002). Enforcement alleged that a former registered representative of a bank-affiliated registered broker-dealer engaged in various sales practice violations, including fraudulent mutual fund switching in at least seven customer accounts (mostly elderly and unsophisticated customers). Enforcement also alleged that the respondent broker-dealer had inadequate mutual fund switching procedures to prevent or detect the registered representative's misconduct and did not have a system in place to communicate, implement, and enforce effectively the switching policies and procedures it did have. The Commission's order found that the respondent failed to supervise reasonably the registered representative, ordered the respondent to pay disgorgement and prejudgment interest in the amount of $3,245.19, and to pay a civil penalty of $150,000. The respondent also agreed to hire an independent consultant to conduct a review of its existing mutual fund switching procedures

7. **In the Matter of Russell C. Turek**, Exchange Act Release No. 45459 (Feb. 20, 2002). Russell Turek was a registered representative associated with a registered broker-dealer. The Commission accepted an offer of settlement from Turek, who had received commissions stemming from his unlawful conduct. The Commission found that on at least seven occasions Turek engaged in improper mutual fund switching. On least two occasions Turek induced the purchase of mutual fund shares resulting in the avoidance of breakpoints (the price level at which the sales charge paid by an investor decreases) in order to increase his commission. He also purchased shares of mutual funds for customers without the customers' authorization and forged customers' signatures. The Commission's order barred Turek from associating with any broker or dealer, ordered him to cease and desist from committing future violations, and ordered him to pay disgorgement and prejudgment interest in the total amount of $1,747.41 and pay a civil money penalty in the amount of $10,000.

8. **In the Matter of Raymond A. Parkins**, Advisers Act Release Nos. 2010 (Jan. 18, 2002) and 1898 (Sept. 25, 2000). Enforcement alleged that Parkins, the president of a registered investment adviser and a broker-dealer formerly registered with the Commission, induced his investment advisory clients to switch their variable annuity investments by providing them with unfounded, false, and misleading justifications for the switches, including false and misleading comparisons of the performances of certain variable annuities and false assurances that the switches would increase the diversification of his clients' portfolios. Parkins, in switch recommendation letters he sent to his clients, misrepresented or failed to inform his clients of the sales charges associated with the switches. As a result of the fraudulent conduct, Parkins' clients incurred unnecessary sales charges and, in some cases, lost a portion of their investment principal. Parkins was ordered to cease and desist from committing or causing any violation or future violations and barred for two years from association with any investment adviser or broker-dealer.

9. **In the Matter of Dale E. Frey**, Exchange Act Release No. 44982 (Oct. 25, 2001); **In the Matter of D.E. Frey and Company**, Exchange Act Release No. 43354 (Sept. 26, 2000). The Commission found that Frey, who was the CEO and a member of the hiring review committee of D.E. Frey, a registered broker-dealer, failed to reasonably supervise its employees. Between 1995 and 1999, three registered representatives at D.E. Frey, each of whom had a

disciplinary history or history of customer complaints, engaged in one or more sales practice abuses including unsuitable trading, unauthorized trading or churning in customer accounts. Frey failed reasonably to supervise those registered representatives and imposed sanctions, including a three-month suspension from the broker-dealer industry, and a 12-month suspension thereafter from serving in a supervisory or proprietary capacity within the broker-dealer industry.

10. In the Matter of J. Stephen Stout, Exchange Act Release No. 43410 (Oct. 4, 2000); Initial Decision No. 134 (Jan.7, 1999); and Securites Act Release No. 7309 (June 28, 1996). Enforcement alleged that Stout, a former salesperson of PaineWebber, Inc., engaged in unsuitable and unauthorized trading and made fraudulent statements and omitted material facts in connection with the offer and sale of securities. Among other things, the Commission found that Stout misled customers about the profitability of their accounts and repeatedly failed to take advantage of mutual fund break-points to minimize the cost of trading for his clients in order to increase the amount of commissions that he received. The Commission's order barred Stout from the broker-dealer industry; ordered him to cease and desist from committing or causing fraud violations; and ordered him to pay a $300,000 penalty.

11. In the Matter of Dean Witter Reynolds, Inc., Exchange Act Release No. 43215 (Aug. 28, 2000) and **In the Matter of Leslie E. Rossello**, Securities Act Release No. 7922 (Dec. 1, 2000). The Commission found that Rossello, a former registered representative of Dean Witter, engaged in at least 48 switch transactions in different accounts. The average time that Rossello's customers held the funds that she switched were eight months; some funds were held for two months before being switched. By switching, Rossello increased the commissions she and Dean Witter received. The switches occurred without the branch manager's prior approval. The Commission found that, while Dean Witter had written supervisory procedures in effect, it did not have a system in place to effectively implement the procedures. As a result, the Commission found that Dean Witter's systems were inadequate to prevent and detect mutual fund switching. The Commission's order provided that: Dean Witter was (a) censured; (b) ordered to remit to certain customers a total of $276,702; (c) ordered to pay a civil penalty of $200,000; and (d) ordered to hire an independent reviewer to review Dean Witter's mutual fund switching procedures and to submit a report to the Commission. Rossello was (a) ordered to cease and desist; (b) suspended from association with any broker-dealer for twelve months; and (c) ordered to pay a civil money penalty of $10,000.

12. In the Matter of the Application of Kenneth C. Krull, Exchange Act Release No. 40768 (Dec. 10, 1998), *aff'd sub nom.* **Krull v. SEC**, 248 F.3d 907 (9th Cir. 2001). The NASD found that Krull, a registered securities representative, switched a number of his customers in and out of a series of common stock mutual funds. Many of these transactions involved a transaction fee at the time of purchase and were subject to a seller's fee if sold within six years. Most of the customers held the mutual funds for less than a year based on petitioner's advice. Krull earned $ 171,000 in commissions and the customers earned $81,705 less than they would have if they had just held their investments long term. The NASD censured Krull, barred him in any principal or supervisory capacity, fined him $20,000, and suspended him for one year in any capacity with the requirement that he requalify as a general securities representative prior to acting again in that capacity. The NASD also ordered Krull to pay restitution of $171,140.93 to his customers with the proviso that such payment will be a condition for Krull's re-entry into

the securities industry following his one-year suspension. The Commission sustained the NASD's sanctions but reduced the restitution amount to $81,705 to clients that had actually lost money.

13. **In the Matter of American Express Financial Advisors Inc.,** Securities Act Release No. 8365 (Feb. 12, 2004). The Commission, in an action announced jointly with the NASD, found that this brokerage firm, during 2001 and 2002, in selling mutual fund shares to customers, failed to provide certain customers with the reductions in front-end loans, or sales charges, also known as "breakpoint" discounts, that were described in the prospectuses of the funds. The Commission's order indicates that the brokerage firm failed to give the appropriate breakpoint discounts in approximately 30 percent of eligible mutual fund transactions, resulting in at least $3.7 million additional costs to customers. The brokerage firm also did not disclose in confirmations the remuneration it received from the sales loads charged to these customers. In settling the matter, the brokerage firm agreed to pay a $3.7 million penalty and pay disgorgement and prejudgment interest to provide customer refunds, and implement procedures to prevent and detect the problems with breakpoint discounts.

14. **In the Matter of Legg Mason Wood Walker, Incorporated**, Securities Act Release No. 8368 (Feb. 12, 2004). See Section M.13., above. The Commission's order indicates that the brokerage firm failed to give the appropriate breakpoint discounts in approximately 35 percent of eligible mutual fund transactions, resulting in at least $2.3 million additional costs to customers. In settling the matter, the brokerage firm agreed to pay a $2.3 million penalty and pay disgorgement and prejudgment interest to provide customer refunds, and implement procedures to prevent and detect the problems with breakpoint discounts.

15. **In the Matter of Linsco/Private Ledger Corp.**, Securities Act Release No. 8371 (Feb. 12, 2004). See Section M.13., above. The Commission's order indicates that the brokerage firm failed to give the appropriate breakpoint discounts in approximately 36 percent of eligible mutual fund transactions, resulting in at least $2.2 million additional costs to customers. In settling the matter, the brokerage firm agreed to pay a $2.2 million penalty and pay disgorgement and prejudgment interest to provide customer refunds, and implement procedures to prevent and detect the problems with breakpoint discounts.

16. **In the Matter of Raymond James Financial Services, Inc.**, Securities Act Release No. 8374 (Feb. 12, 2004). See Section M.13., above. The Commission's order indicates that the brokerage firm failed to give the appropriate breakpoint discounts in approximately 32 percent of eligible mutual fund transactions, resulting in at least $2.6 million additional costs to customers. In settling the matter, the brokerage firm agreed to pay a $2.6 million penalty and pay disgorgement and prejudgment interest to provide customer refunds, and implement procedures to prevent and detect the problems with breakpoint discounts.

17. **In the Matter of UBS Financial Services, Inc.**, Securities Act Release No. 8377 (Feb 12, 2004). See Section M.13., above. The Commission's order indicates that the brokerage firm failed to give the appropriate breakpoint discounts in approximately 30 percent of eligible mutual fund transactions, resulting in at least $4.6 million additional costs to customers. In settling the matter, the brokerage firm agreed to pay a $4.6 million penalty and pay disgorgement

and prejudgment interest to provide customer refunds, and implement procedures to prevent and detect the problems with breakpoint discounts.

18. **Wachovia Securities, LLC**, Securities Act Release No. 8380 (Feb. 12, 2004). See Section M.13., above. The Commission's order indicates that the brokerage firm failed to give the appropriate breakpoint discounts in approximately 29 percent of eligible mutual fund transactions, resulting in at least $4.8 million additional costs to customers. In settling the matter, the brokerage firm agreed to pay a $4.8 million penalty and pay disgorgement and prejudgment interest to provide customer refunds, and implement procedures to prevent and detect the problems with breakpoint discounts.

19. **In the Matter of H.D. Vest Investment Securities, Inc.**, Securities Act Release No. 8383 (Feb. 12, 2004). See Section M.13., above. The Commission's order indicates that the brokerage firm failed to give the appropriate breakpoint discounts in approximately 33 percent of eligible mutual fund transactions, resulting in at least $725,000 additional costs to customers. In addition, the Commission found that this brokerage firm made unsuitable sales of class B mutual fund shares, and failed to tell these customers that an equivalent investment in class A shares could yield higher returns as a result of breakpoint discounts and reduced ongoing expenses. These unsuitable transactions earned the brokerage firm $691,000 in excess commissions. In settling the matter, the brokerage firm agreed to pay a $1.4 million penalty and pay disgorgement and prejudgment interest to provide customer refunds, and implement procedures to prevent and detect the problems with breakpoint discounts and recommendations of class B shares.

PREPARED STATEMENT OF PAUL F. ROYE

DIRECTOR, DIVISION OF INVESTMENT MANAGEMENT
U.S. SECURITIES AND EXCHANGE COMMISSION

MARCH 10, 2004

Introduction

Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee, it is both a pleasure and an honor to testify before you today. On behalf of the Securities and Exchange Commission (the "Commission"), I am pleased to discuss the Commission's recent regulatory actions to protect mutual fund investors. To address the various abuses that have come to light in recent months, the Commission has embarked on a dramatic overhaul of the regulatory framework in which mutual funds operate. The Commission's regulatory actions, taken together with its recent enforcement proceedings and actions by State securities regulators, are intended to prevent and deter the types of market timing, late trading and sales practice abuses that have dominated the headlines in recent months. Equally important, the Commission's rulemaking initiatives are aimed at restoring the trust and confidence of investors that are crucial to the continued success of the mutual fund industry and preserving their key role in our country's economy.

Approximately 95 million investors have entrusted over $7 trillion dollars to mutual funds. As mutual fund investments increasingly fund the most important personal goals in Americans' lives, from retirement and education savings to charitable giving, our Nation's investors rightfully look to fund managers and fund directors to act in their interests. Sadly, these investors have been let down, as some of those charged with protecting investors have willfully disregarded their responsibilities to act for the benefit of their investors.

The Commission has committed its unceasing effort to holding accountable those who violate the Federal securities laws to abuse fund investors. The Commission is equally devoted to enhancing the mutual fund regulatory framework so that it best serves fund investors.

Commission's Regulatory Agenda

Under Chairman Donaldson's leadership, the Commission is pursuing an aggressive mutual fund regulatory agenda that is focused on four main goals: (1) addressing late trading, market timing and related abuses; (2) improving the oversight of funds by enhancing fund governance, ethical standards, and compliance and internal controls; (3) addressing or eliminating certain conflicts of interest in the industry that are potentially harmful to fund investors; and (4) improving disclosure to fund investors, especially fee-related disclosure. Outlined below is an overview of the Commission's recent regulatory actions in each of these areas.

INITIATIVES TO ADDRESS LATE TRADING, ABUSIVE MARKET TIMING, AND RELATED ABUSES

Late Trading

Every day hundreds of thousands of investors purchase or redeem shares of mutual funds. The price they pay (or receive) turns on when the order is submitted and to whom. Typically, funds price their shares at 4 p.m. Investors submitting orders before 4 p.m. receive that day's price; investors submitting orders after 4 p.m. get the next day's price. This is a simple, but very important concept known as "forward pricing." If you can place an order to buy or sell fund shares after 4 p.m., and still receive the price set at 4 p.m., you can profit from new information in the marketplace at the expense of other fund shareholders. The Commission's recent review of the largest brokers that sell fund shares identified numerous instances of late trading of fund shares. It is just plain cheating, and something that clearly violates existing Commission rules.

The current rules permit a large number of intermediaries that accept or transmit trades in fund shares to determine whether the order will receive that day's 4 p.m. price. Typically, investor trades are accepted throughout the business day by fund transfer agents, as well as brokers, banks, and retirement plan administrators—so-called fund intermediaries. These intermediaries pass on orders to fund companies in batches at the end of the day after 4 p.m. They are only supposed to pass on orders they receive before 4 p.m. This system, which was first created 35 years ago, relies heavily on the honesty of fund intermediaries to segregate orders based on the time they are received and then playing by the rules.

We know today that this system failed. In order to help favored customers, certain intermediaries have "blended" legitimate (pre-4 p.m. orders) with late trades (post-4 p.m. orders). In some cases, fund managers participated in the scheme; but in

many cases they were the victims of dishonesty along with fund investors. The problem is that fund companies have no way of identifying a late trade when it is bundled with legitimate trades and submitted to the fund company in the evening hours. There are potentially enormous profits to be gained by late trading, and all of those profits come out of the pockets of mutual fund investors.

To address this abuse, the Commission proposed the so-called "Hard 4 p.m. Close" rule. This proposal would require that a fund or a certified clearing agency, such as NSCC—rather than an intermediary such as a broker-dealer or other unregulated party—receive a purchase or redemption order prior to the time the fund prices its shares (which, as previously stated, is typically 4 p.m.) for an investor to receive that day's price. We believe that this rule amendment will provide for a secure pricing system that would be highly immune to manipulation by late traders.

We are currently analyzing the comment letters we received during the comment period on this proposal, which closed on February 6th. While we believe the proposed rule amendment would virtually eliminate the potential for late trading through intermediaries that sell fund shares, it is clear from the comments that some believe that the hard 4 p.m. rule is not the preferred approach. They argue that it will require the intermediaries to have cut-offs for orders well before 4 p.m. and limit investor opportunities to place orders for fund transactions, particularly in the 401(k) context. Consequently, we are studying other approaches to addressing this issue. We do not want to adversely impact fund investors if there are alternatives that effectively—truly effectively—address late trading abuses.

Market Timing

The Commission has taken a number of steps to address abusive market timing of mutual funds. Short-term trades in mutual fund shares impose costs on funds and their long-term investors. Some market timers attempt to purchase and redeem fund shares to take advantage of market actions they believe will occur in the future. Other types of market timers attempt to more directly take advantage of the fund's long-term shareholders by exploiting how funds calculate their net asset value. These "arbitrage market timers" buy and sell shares of funds if they believe that the fund's calculation of net asset value significantly lags behind the current value of a fund's portfolio securities, typically in international funds or other funds that invest in thinly traded securities. Over time, the long-term shareholders in a fund will, in effect, pay the costs of the short-term shareholders' transactions and have the value of their fund shares diluted through the activity of arbitrage market timers.

Fair Value Pricing

To help prevent "arbitrage market timing," the Commission has stressed that "fair value pricing" is a critical tool in effectively reducing or eliminating the profit that many market timers seek. The Investment Company Act requires funds to calculate their net asset values using the market value of portfolio securities when market quotations are readily available. If a market quotation for a portfolio security is not readily available (or is unreliable), the fund must establish a "fair value" for that security, as determined in good faith by the fund's board of directors. Fair value pricing can minimize market timing, and eliminate dilution of shareholders' interests. In a recent release adopting the new compliance procedures rule, the Commission reiterated the obligation of funds to fair value their securities to reduce market timing arbitrage opportunities. Additionally, the Commission has proposed improved disclosure of a fund's policies and procedures regarding fair value pricing. SEC staff are currently gathering information regarding funds' fair value pricing practices and evaluating whether to recommend additional measures to improve funds' fair value pricing. The Commission has also sought public comment on the need for additional guidance or rulemaking in this area.

Mandatory Redemption Fee

In a further effort to reduce the profitability of abusive market timing, the Commission just late last month put forth a proposal that would require funds to impose a mandatory 2 percent redemption fee when investors redeem their shares within 5 business days. This fee would be payable to the fund, for the direct benefit of fund shareholders, rather than to the management company or any other service provider.

The 2 percent fee is designed to strike a balance between two competing policy goals of the Commission—preserving the redeemability of mutual fund shares and reducing or eliminating the ability of shareholders who frequently trade their shares to profit at the expense of their fellow shareholders. Combined with fair value pricing, the Commission felt that the rule would make market timing less profitable, and therefore reduce the incentive to engage in market timing. The Commission is

considering whether a 2 percent redemption fee is an appropriate approach to addressing short-term trading, including abusive market timing.

Enhanced Disclosure Related to Abusive Activities

The Commission also has proposed enhanced disclosure requirements in order to combat abuses in the areas of market timing and the related issue of selective disclosure of portfolio holdings. These enhancements are intended to deter abusive practices and to enable investors to better understand a fund's policies in these areas. The Commission proposed amendments to require more open and unambiguous disclosure with respect to the methods that mutual funds use to combat market timing activity. Among other changes, the Commission's proposed reforms would:

- Require a mutual fund to describe in its prospectus the risks that frequent purchases and redemptions of fund shares may present for other fund shareholders.
- Require that a mutual fund state in its prospectus whether the fund's board of directors has adopted policies and procedures with respect to frequent purchases and redemptions of fund shares. If the board has not adopted any such policies and procedures, the fund's prospectus would be required to state the specific basis for the view of the board that it is appropriate for the fund not to have such policies and procedures.
- Mandate that a fund describe with specificity any policies and procedures for deterring frequent purchases and redemptions of fund shares, and any arrangements that exist to permit frequent purchases and redemptions of fund shares. This description must include any restrictions on the volume or number of purchases, redemptions, or exchanges that a shareholder may make, any exchange fee or redemption fee, and any minimum holding period that is imposed before an investor may make exchanges into another fund. Moreover, a fund would be required to indicate whether each restriction applies uniformly in all cases, or whether the restriction will not be imposed under certain circumstances, and to describe any such circumstances with specificity.

Selective Disclosure of Portfolio Holdings

The Commission also proposed amendments intended to provide greater transparency of fund practices with respect to the disclosure of a fund's portfolio holdings. Specifically, a fund would be required to describe its policies and procedures with respect to the disclosure of its portfolio securities, including any arrangements to make available information about the fund's portfolio securities, the identity of any persons who receive such information, and any compensation or other consideration received by a fund or its investment adviser in connection with such arrangements. These amendments do not alter the requirement that a mutual fund or investment adviser may disclose a fund's portfolio of investment securities only if the disclosure of such information is consistent with the antifraud provisions of the Federal securities laws and the fiduciary duties owed to fund shareholders.

This new disclosure requirement should have the effect of requiring fund management to carefully assess the propriety and circumstances under which portfolio holding information is divulged, as well as inform fund investors of the fund's policies in this area.

INITIATIVES TO ENHANCE FUND OVERSIGHT

The recent mutual fund scandals have highlighted the need to improve oversight of the industry, and the Commission has undertaken several initiatives on this front. These initiatives are designed to strengthen the hand of the fund's board and to provide the directors, particularly the independent directors, additional tools with which to protect fund investors, as well as reinforce ethical standards.

Fund Governance

In January, the Commission proposed a comprehensive rulemaking package to bolster the effectiveness of independent directors and to enhance the role of the fund board as the primary advocate for fund shareholders. The proposals included a requirement for: (i) an independent board chairman; (ii) 75 percent independent directors; (iii) independent director authority to hire, evaluate, and fire staff; (iv) quarterly executive sessions of independent directors outside the presence of management; (v) an annual board self-evaluation; and (vi) preservation of documents used by boards in the contract review process.

This significant overhaul of the composition and the workings of fund boards is intended to establish, without ambiguity, the dominant role of independent directors on a fund's board. With an independent board chairman and with independent directors representing at least 75 percent of a fund's board, the independent directors

will set the board agenda, as well as have the power to control the outcome of board votes.

The very nature of external management that characterizes the U.S. fund industry creates conflicts of interest, particularly when personnel of fund advisers may be tempted by opportunities to benefit the adviser over fund shareholders. While not a guarantee that all conflicts of interest will be resolved in the best interests of shareholders, a board composed of an independent chairman and a super-majority of independent directors is more likely to be an effective check on management, particularly when so much of the board's responsibility involves policing the management company's conflicts of interest.[1] As Chairman Donaldson recently commented, "a fund board can be more effective when negotiating with the fund adviser over matters such as the management fee, if it were not at the same time led by an executive of the adviser with whom the board is negotiating."

By empowering independent fund directors to retain staff, in conjunction with the role envisioned for the newly-required chief compliance officer, the Commission's proposals emphasize the importance of boards relying on experts other than advisory personnel to provide information in appropriate circumstances. In addition, reinforcing the ability of the board to hire staff recognizes that directors often must make decisions on issues about which they may need to seek out expertise, such as the fair value pricing of portfolio securities.

Boards would also be required to perform a thorough self-evaluation in order to identify structural changes and processes that might enable the board to be a more potent advocate for shareholder interests. Boards would be required to assess periodically whether they are organized to maximize their effectiveness. As part of this evaluation, boards would consider the number of fund boards on which individual board members sit, as well as consider the nature and effectiveness of their board committee structures.

As part of its effort to enhance fund governance, the Commission has proposed to mandate that funds keep copies of the materials directors considered when reviewing the fund's advisory contract each year. This amendment is designed to give the Commission's examinations staff access to the information on which directors rely when performing this crucial function. This requirement also could have the effect of focusing directors on this key information, since they would be aware that it will be subject to Commission scrutiny.

Adviser Codes of Ethics and Fund Transactions Reporting

The Commission recently proposed that all registered investment advisers adopt codes of ethics. Investment advisers are fiduciaries, and owe their clients a series of duties enforceable under the Investment Advisers Act's antifraud provisions. This bedrock principle, which historically has been a core value of the money management business, appears to have been lost on a number of advisers and advisory personnel.

The Commission believes that prevention of unethical conduct by advisory personnel is part of the answer to avoiding the problems we have encountered recently. Consequently, the code of ethics would set forth standards of conduct for advisory personnel that reflect the adviser's fiduciary duties, as well as codify requirements to ensure that an adviser's supervised persons comply with the Federal securities laws, and require that supervised persons receive and acknowledge receipt of a copy of the code of ethics. In addition, the code of ethics must include provisions that address the safeguarding of material nonpublic information about client transactions, reporting promptly any violations of the code of ethics, and mandating preclearance of personal investments in initial public offerings and private offerings.

Finally, the ethics code is designed to address conflicts that arise from the personal trading of advisers' employees. A principal feature of the code of ethics rule is a requirement that certain advisory personnel, referred to as access persons, must report their personal securities holdings and transactions, including transactions in any mutual fund managed by the adviser or an affiliate. The rule would close a loophole in the Investment Company Act under which investment company personnel have not been required to report trading in shares of funds they manage. This loophole became apparent when, unfortunately, fund personnel were discovered market timing their own funds.

[1] At the open meeting at which the Commission proposed the rule, Commissioners Glassman and Atkins questioned whether an independent chairman would in fact provide a more effective check on management and thus be more effective in promoting shareholder interests.

Compliance Policies and Compliance Officer

In an action we expect to have a far-reaching positive impact on mutual fund operations and compliance programs, the Commission in December adopted rules that require funds and their investment advisers to have comprehensive compliance policies and procedures in place, and to designate a chief compliance officer. In the case of a fund, the chief compliance officer would be answerable to the fund's board and fired only with the board's consent.

The compliance officer has dual roles: First, as the primary architect and enforcer of compliance policies and procedures for the fund; second, and perhaps more importantly, as the eyes and ears of the board on all compliance matters. The chief compliance officer, at the behest of the board, is expected to strengthen the board's hand of compliance oversight into the details of the operations of funds and advisers, where compliance lapses and abuses often germinate and remain hidden from even the most watchful board. In order to support the "watchdog" role of the compliance officer, the rules require the chief compliance officer to meet in executive session with the independent directors at least once each year, outside the presence of fund management and the interested directors. This executive session will create an opportunity for open dialogue between the chief compliance officer and the independent directors and encourage the compliance officer to speak freely about any sensitive compliance issues, such as any reservations about the cooperativeness or compliance practices of fund management. To insulate a chief compliance officer from the pressures, real or perceived, brought to bear by fund management, a fund's board, including a majority of the independent directors, must approve the chief compliance officer's compensation, as well as any changes in compensation.

To further encourage a culture of compliance among fund officers and personnel of fund advisers, the compliance rule calls for funds and advisers to adopt policies and procedures designed to lessen the likelihood of securities law violations. The adequacy of these policies and procedures must be reviewed at least annually in order to ensure that fund directors assess whether internal controls and procedures are working well and whether certain areas can be improved.

An active and independent board of directors, supplied with reliable information as to the effectiveness of compliance programs and procedures, can serve as an important check against abuse and fraud on the part of fund management.

INITIATIVES AIMED AT CONFLICTS OF INTEREST

In addition to the matters outlined above, the Commission is undertaking a series of initiatives aimed at certain conflicts of interest involving mutual funds and those who distribute fund shares.

Directed Brokerage

Last month, the Commission voted to propose an amendment to Rule 12b–1 to prohibit the use of brokerage commissions to compensate broker-dealers for distribution of a fund's shares. Effectively, this proposal would ban so-called directed brokerage practices by mutual funds. When Rule 12b–1 was adopted by the Commission in 1980, the Commission thought that it would be relatively benign to permit funds to consider distribution when making brokerage allocation decisions. However, in recent years, it has become clear that the practice of directing a fund's brokerage to a broker or dealer as compensation for distribution of a fund's shares presents opportunities for abuse. Advisers to funds are allocating brokerage commissions to pay for distribution when they could seek lower commission rates, rebates to the fund, or reduce custody, transfer agency or other fund costs. The use of directed brokerage to pay for distribution benefits fund advisers by increasing their advisory fees, which generally are based on the size of fund assets, and lowering the amount they have to spend on distribution out of their own assets. The conflicts of interest that surround the use of brokerage commissions (which, of course, are fund assets) to finance distribution can harm funds and their shareholders. Directed brokerage practices potentially could compromise best execution of portfolio trades, increase portfolio turnover, conceal actual distribution costs, and corrupt broker-dealers' recommendations to their customers. Therefore, the Commission has proposed to ban these types of arrangements.

Rule 12b–1

At the same time, the Commission voted to request comment on the need for additional changes to Rule 12b–1. Over time, Rule 12b–1 has come to be used in ways that exceed its original purpose. Consequently, the Commission is seeking comment on whether Rule 12b–1 continues to serve the purpose for which it was intended and whether it should be repealed. To address concerns that Rule 12b–1 fees have replaced sales loads in many cases, the Commission also requested comment on an

alternative approach to Rule 12b–1 that would require distribution-related costs to be deducted directly from shareholder accounts rather than from fund assets. Under this approach, a shareholder would pay the same sales load regardless of when the load is paid. An investor could pay the load at the time of purchase or over the period of the investment, with any remaining load paid upon redemption. This approach may have a number of advantages: First, actual sales charges would be clear to investors; second, existing shareholders would not pay for sales to new investors; and third, long-term shareholders would not pay 12b–1 fees that may exceed their fair share of distribution costs.

Soft Dollars

Chairman Donaldson has made the issue of soft dollars a priority and has directed the staff to explore the problems and conflicts inherent in soft-dollar arrangements and the scope of the safe harbor contained in Section 28(e) of the Securities Exchange Act. The Divisions of Market Regulation and Investment Management are working together to conduct this review. A primary area of focus is whether the current definition of qualifying "research" under the safe harbor is too broad and should be narrowed by rulemaking. The Commission has also sought public comment on whether it would be possible to require mutual fund managers to identify the portion of Commission costs that purchase research services from brokers so as to enhance the transparency of these arrangements.

INITIATIVES TO IMPROVE FUND DISCLOSURE, INCLUDING FEE-RELATED INFORMATION

The Commission is quickly progressing on its continued effort to improve fund disclosures and highlight for investors fee-related information. This effort began long before mutual fund scandals hit the headlines, and Chairman Donaldson has identified improved disclosure as a priority for the Commission's mutual fund program.

Shareholder Reports Disclosure

The level of a fund's expenses, over time, has a significant impact on a fund shareholders' investment experience. The Commission has wrestled for years with the problem of how to convey expense information to investors in a cost-effective way that permits investors to compare funds and to understand and appreciate the effect that expenses have on their investment. Last month, the Commission voted to significantly revise mutual fund shareholder report disclosures to assist investors in understanding these expenses. Shareholder reports will now be required to include dollar-based expense information for a hypothetical $1,000 investment. Using that information, investors can then estimate the dollar amount of expenses paid on their investment in a fund. Shareholder reports also will contain the dollar amount of expenses an investor would have paid on a $1,000 investment in the fund, using an assumed rate of return of 5 percent. Using this second dollar-based number, investors can compare the level of expenses across various potential fund investments. Increased transparency of fees should enhance fee-based competition in the fund industry.

This initiative also includes significantly improved disclosure to investors about a fund's investments. The recent amendments will replace a one-size-fits-all approach to portfolio holdings disclosure, where all funds deliver their full portfolio schedules to all their shareholders twice a year, with a layered approach that will make more information available, while permitting investors to tailor the amount of information they receive to meet their particular needs. The additional quarterly disclosure of fund portfolio holdings will enable interested investors, through more frequent access to portfolio information, to better monitor whether, and how, a fund is complying with its stated investment objective. The amendments also require shareholder reports to include tables, graphs, or charts that concisely, and in a user-friendly format, effectively convey key information about a fund's portfolio. Finally, management's discussion of fund performance is now required to appear in annual shareholders reports, and should assist investors in assessing the fund's performance over the prior year. This package of initiatives will provide better information to investors regarding fund costs, investments, and fund performance.

At the same time as it adopted these revisions, the Commission proposed to require disclosure in fund shareholder reports about how fund boards evaluate investment advisory contracts. A fund's board of directors plays a key role in negotiating and approving the terms of the advisory contract between the fund and the investment adviser who is charged with its management. The Commission is proposing to make this process more transparent to fund shareholders. The disclosure would include discussion of the material factors considered by the board and the conclusions with respect to those factors that formed the basis for the board's approval or renewal of the advisory contract. In making this proposal, the Commission is seeking to promote insightful disclosure of the board review process, rather than

meaningless boilerplate that is not helpful to investors. Transparency of fees, informed investors and independent, vigorous boards of directors will allow the market to determine appropriate fee levels. This proposal should encourage fund boards to consider investment advisory contracts more carefully and encourage investors to consider more closely the costs and value of the services rendered by the fund's investment advisers.

Fund Advertising

In September, the Commission adopted amendments to raise the standards for mutual fund performance advertising. The amended rules require that fund advertisements state that investors should consider fees, as well as investment objective and risks, before investing and that advertisements direct investors to a fund's prospectus to obtain additional information about fees, investment objectives and risks. The rules also require more balanced information when mutual funds advertise performance, as well as provide ready access to more timely performance information.

Mutual Fund Confirmation Form and Point-of-Sale Document

In a major proposal issued in January, the Commission proposed significant revisions to mutual fund confirmation forms and also proposed the first-ever point-of-sale disclosure document for brokers selling mutual fund shares. Together, these two proposals would greatly enhance the information that broker-dealers provide to their customers in connection with mutual fund transactions.

The proposals call for disclosure of targeted information, at the point-of-sale and in transaction confirmations, regarding the costs and the conflicts of interest that arise from the distribution of mutual fund shares. The point-of-sale document would provide information to investors prior to transactions in mutual fund shares regarding the distribution-related costs that the customers would be expected to incur in connection with the transaction, including information regarding the sales loads, asset-based sales charges and services fees paid out of fund assets, whether the broker-dealer receives revenue sharing payments or portfolio brokerage commissions from the fund complex, as well as whether it pays differential compensation in connection with different classes of shares or proprietary products. The new mutual fund confirmation form incorporates and quantifies these same disclosures. In an effort to ensure that these disclosure documents will be as meaningful as possible to investors, the Commission has directed the staff to gather information from investors—through educational summits, focus groups and other means—so that the Commission has meaningful input from the actual investors who will benefit from these disclosures.

Breakpoints Disclosure

In light of the wide-scale failure to provide appropriate breakpoint discounts on front-end load mutual fund purchases, the Commission in December proposed improved prospectus disclosure about fund breakpoints. This disclosure is designed to highlight for investors the availability of breakpoint discounts and implements recommendations made by a Joint NASD/Industry Taskforce that convened to study and make recommendations to improve the identification and processing of breakpoint opportunities for fund investors.

Transaction Costs Concept Release

Also in December, the Commission issued a concept release requesting comment on methods to calculate and improve the disclosure of funds' portfolio transaction costs. Transaction costs can represent a significant portion of the overall expenses incurred by a mutual fund. Although transaction costs are taken into account in computing a fund's total return, there is a concern that investors do not fully understand the impact of transaction costs on their fund investments because those transaction costs are not separately disclosed in a fund's expense table. However, there is no agreed-upon, uniform method for the calculation of fund transaction costs. Thus, the Commission issued its concept release to elicit helpful commentary to guide us as we pursue this issue.

Portfolio Managers

Finally, on March 11, the Commission is considering new proposals to improve disclosure to fund shareholders about their portfolio manager's relationship with the fund. These proposals include disclosure regarding the structure of portfolio manager compensation, ownership of shares of the funds that a manager advises, and comprehensive disclosure of specific investment vehicles, including hedge funds and pension funds, that are also managed by the mutual fund's portfolio manager. This proposal will also require clear disclosure as to who is managing a fund, addressing

the current requirement that allows advisers to use a portfolio management team to avoid identifying the principal managers of the fund.

Conclusion

As should be evident, the Commission has been extremely busy in proposing and adopting rules that are designed to protect our Nation's mutual fund investors. Our focus has been directed not only on addressing the harms of late trading, abusive market-timing and related abuses, but also on strengthening the mutual fund oversight and regulatory framework to minimize the possibility that these and other potential abuses arise in the future and on taking steps to provide meaningful and useful disclosure to facilitate informed decisionmaking on the part of mutual fund investors. Again, I would like to thank you for the opportunity to be here today to discuss the Commission's recent regulatory actions to protect mutual fund investors. I would be pleased to answer any questions you may have.

PREPARED STATEMENT OF MARY L. SCHAPIRO

VICE CHAIRMAN AND PRESIDENT, REGULATORY POLICY AND OVERSIGHT
NATIONAL ASSOCIATION OF SECURITIES DEALERS (NASD)

MARCH 10, 2004

Mr. Chairman and Members of the Committee, NASD would like to thank the Committee for the invitation to submit this written statement for the record.

NASD

NASD is the world's preeminent private sector securities regulator, established in 1939 under authority granted by the 1938 Maloney Act Amendments to the Securities Exchange Act of 1934. We regulate every broker-dealer in the United States that conducts a securities business with the public—nearly 5,200 securities firms that operate more than 92,000 branch offices and employ more than 663,000 registered representatives.

Our rules comprehensively regulate every aspect of the brokerage business, and NASD examines broker-dealers for compliance with NASD rules, MSRB rules, and the Federal securities laws—and we discipline those who fail to comply. Last year, 2003, NASD filed a record number of new enforcement actions (1,410) and barred or suspended more individuals (827) from the securities industry than ever before. Our market integrity and investor protection responsibilities include examination, rule writing, professional training, licensing and registration, dispute resolution, and investor education. NASD monitors all trading on the Nasdaq Stock Market—more than 70 million orders, quotes, and trades per day. NASD has a Nationwide staff of more than 2,000 and is governed by a Board of Governors, more than half of whom are unaffiliated with the securities industry.

NASD Oversight of Mutual Fund Sales

Millions of Americans invest in mutual funds each year. The NASD is deeply disturbed by recent revelations of a wide range of abuses that undermine the confidence of mutual fund investors and the integrity of the industry. Portfolio managers have traded ahead of mutual fund investors, released portfolio information differentially and selectively, and made deals with preferred customers to permit market timing and late trading. NASD does not have jurisdiction or authority over mutual funds or their advisers. Nevertheless, we do regulate broker-dealers who sell mutual funds, including mutual fund underwriters. Broker-dealer participation in illegal or unethical sales practices in the sale of mutual fund shares is a matter of immediate concern to NASD.

NASD reviews mutual fund advertisements, whether they appear in a magazine or newspaper, radio or television commercial. We vigorously enforce our suitability rule and our prohibition against compensation arrangements that create unacceptable conflicts of interest in the sale of mutual fund shares.

During 2003 and 2004, NASD brought more than 80 enforcement actions for violations concerning the sale of mutual funds and pooled investment products. The violations in these cases included suitability of the mutual fund share classes that brokers recommended, sales practices, improper disclosures, and compensation arrangements between the funds and brokers. These actions bring to more than 200 the number of cases NASD has taken in the investment company area since 2000. In addition, and most recently, NASD has brought enforcement actions dealing with market timing and the improper failure of a broker-dealer to waive certain sales

charges, and 15 cases involving the failure to deliver breakpoint discounts on shares with front-end load sales charges.

NASD Oversight of Mutual Fund Advertising

The NASD requires that all advertisements and other sales material issued by broker-dealers be fair, balanced, and not misleading. Every mutual fund advertisement distributed through the media and every mutual fund sales brochure issued by a broker-dealer must be filed with NASD. We review these advertisements and sales pieces to ensure that they comply with the highest standards of fair and balanced disclosure. This undertaking is significant: In 2003, NASD reviewed over 80,000 investment company sales pieces.

When a broker-dealer's mutual fund sales material fails to meet applicable standards, NASD staff directs the firm either to revise the material to meet applicable standards or to stop using the material entirely. NASD also brings enforcement actions against broker-dealers that violate our advertising rules.

One of the most important issues that NASD has addressed in our administration of the advertising rules concerns the manner in which mutual funds advertise their past performance. Too often, mutual fund advertisements stress their impressive past performance by the advertised fund, without providing balanced disclosure concerning the fees and the expenses that investors incur when they purchase and own shares of the fund. Yet these fees and expenses can have a significant impact on the long-term future performance of a mutual fund investment an investor makes today.

In December, NASD proposed to amend our advertising rules to require that every advertisement that promotes a mutual fund's performance also presents the fund's fees and expenses in a prominent text box, not in a footnote. This would include the fund's maximum front-end and back-end sales load, if any, and the fund's ongoing expense ratio, including any 12b–1 fees. The proposal also would require that the text box contain the standardized 1-, 5-, and 10-year total return performance required by the SEC.

This proposal, which NASD filed with the SEC earlier this week, would help investors compare mutual funds and would make the costs of purchasing and owning mutual funds more apparent. NASD looks forward to working with the SEC staff on this proposal and to its prompt adoption and implementation.

Compensation Arrangements between Brokers and Funds

NASD recognizes that compensation arrangements between mutual funds and brokers can inappropriately influence the investment recommendations that brokers make to their retail customers. Accordingly, NASD has taken a number of steps, both in terms of rulemaking and enforcement of existing rules, to help ensure that investors are protected from misleading practices.

NONCASH COMPENSATION

NASD prohibits most forms of noncash compensation, such as luxury cruises, trips and lavish entertainment, for the sale of mutual fund shares. These compensation arrangements present a conflict of interest for sales personnel and interfere with the ability of regulated firms to supervise their sales forces. In September 2003, NASD sanctioned Morgan Stanley DW, Inc. and fined the firm $2 million for sponsoring sales contests that awarded meals, trips, concert tickets, and other prizes to sales representatives that met certain sales targets and favored Morgan Stanley proprietary funds. NASD also charged Morgan Stanley and the head of its retail sales division with supervisory violations, because Morgan Stanley failed to have any supervisory systems or procedures in place to detect and prevent this widespread misconduct.

DIRECTED BROKERAGE COMPENSATION

NASD rules have long addressed the possibility that a mutual fund may direct its portfolio brokerage to a broker-dealer in exchange for the broker-dealer's commitment to feature or promote the sale of the fund's shares. Such an arrangement presents a potential conflict of interest for the investment adviser to the mutual fund, who must execute the fund's portfolio transactions; it also presents a conflict for the broker-dealer, who may recommend fund shares to its customers in order to reap brokerage commissions from the fund. NASD prohibits any broker-dealer from accepting brokerage commissions from a mutual fund as a condition to favoring the sale of the fund's shares. Exchanging prominent placement of a fund or family of funds on a firm's website or in the firm's marketing material or placing a fund on a "featured" or "preferred" list of funds in exchange for brokerage commissions from the fund may be misleading to investors and is a violation of NASD rules.

In November 2003, NASD and the SEC sanctioned and fined Morgan Stanley $50 million for violations of this rule due to its use of directed brokerage arrangements to promote sales of its proprietary funds. In return for brokerage commissions and other payments, Morgan Stanley gave 16 of 115 mutual fund families it sold preferential treatment, including placement on a "preferred list" of funds that financial advisers were to look to first in making recommendations of fund products; higher visibility on Morgan Stanley's sales systems and workstations; eligibility to participate in the firm's 401(k) programs and to offer offshore fund products to Morgan Stanley customers; better access to its sales force and branch managers; and payment of special sales incentives to Morgan Stanley financial advisers.

NASD recently proposed to expand these directed brokerage prohibitions. Under our proposal, a broker-dealer would be prohibited from selling shares of any mutual fund that even considers its fund sales as a factor in selecting a broker-dealer to execute its trades. The SEC has proposed a similar amendment to its Rule 12b–1.

REVENUE SHARING AND DIFFERENTIAL COMPENSATION

In September 2003, NASD proposed new rules to address "revenue sharing" and "differential compensation" arrangements. Frequently, mutual funds seek to improve the sales of their shares by paying for "shelf space" at a broker-dealer. This practice, commonly known as "revenue sharing," can take a variety of forms, including sharing of advisory fees, direct cash payments, and reimbursing brokers for their sales and training-related expenses. Our rule proposal would require every broker-dealer to disclose to its customers whether the firm accepts revenue sharing payments from funds. The broker-dealer would have to list the funds in order based on the amount of revenue sharing received. Broker-dealers also would have to periodically update the list of funds that pay revenue sharing to the firm and make the list available through a website, toll-free telephone number, or customer mailings.

In addition, some broker-dealers may pay "differential compensation" to their sales force. Under these arrangements, a broker-dealer may pay its sales representatives higher compensation for the sale of certain funds, such as a firm's proprietary fund family or funds that pay revenue sharing to be included on a preferred list. Our proposal would require broker-dealers to disclose these differential compensation arrangements to their customers and to name the funds that benefit from these arrangements.

The SEC recently issued its own proposal that would require brokers to make similar disclosures regarding revenue sharing and differential cash compensation at the point-of-sale and as part of a customer's sales confirmation statement. We are reviewing this proposal and we will work with the SEC both on its proposal and on how best to proceed with our own rule proposal.

Suitability of the Fund Sales

Many mutual funds offer different classes of the same investment portfolio. Each class provides broker-dealers and their customers with a choice of distribution fee structure. For example, Class A shares charge a "front-end" sales load when the customer purchases shares and they may impose an ongoing distribution fee, called a Rule 12b–1 fee. Class B shares do not impose a "front-end" sales load, but they do impose higher annual Rule 12b–1 fees which are assessed over the first 6 to 8 years of their investment or until they convert into Class A shares. Class B shares normally impose a "contingent deferred sales charge" (CDSC) which a customer pays if the customer sells the shares within first six or eight years. This CDSC declines over time during that 6- or 8-year period. Class C shares usually do not impose a front-end sales load, but often impose a load if a customer sells shares within a short time of purchase, usually 1 year. Class C shares typically impose higher Rule 12b–1 fees than Class A shares, and, unlike Class B shares, do not convert into a lower expense class following a specified holding period.

While Class A shares impose a front-end sales load, most mutual funds offer a reduced load, or "breakpoint," for large purchases. NASD has found that some broker-dealers have recommended Class B shares in such large amounts that the customer would have qualified for significant breakpoint discounts had the broker-dealer recommended Class A shares instead. Some broker-dealers also have recommended transactions in Class B shares that are so frequent as to cause the customer to incur CDSC charges. In both cases, the broker may receive higher compensation for the Class B recommendations. NASD has vigorously prosecuted these violations of our rules, and we are continuing our comprehensive monitoring of Class B share sales practices. Over the last 2 years, NASD has brought more than a dozen enforcement actions against firms and individual brokers for these types of violations. Currently, NASD has more than 50 active investigations in this area.

Discounts for Customers

One area that has been a focus for NASD in recent months is reviewing whether brokers are giving their customers all the discounts and waiver of sales charge benefits to which they are entitled when buying certain funds.

NAV TRANSFER PROGRAMS

Some mutual fund families offer programs that essentially permit a customer to exchange shares from another fund family at the new fund's net asset value (NAV), without paying the front-end sales load. These programs permit customers to purchase Class A shares without paying a front-end sales load, if in purchasing those shares the customer used proceeds from a recent redemption of shares of another load fund. Investors who qualify for NAV transfer programs have no reasonable basis to purchase any class of shares other than Class A shares.

Last month, the NASD brought the first enforcement action involving a broker-dealer's failure to obtain sales load waivers for mutual fund customers through these NAV transfer programs. NASD fined AXA Advisors, LLC $250,000 for these failures. We also jointly fined a senior vice president of the firm $50,000.

NASD found that the firm failed to have an adequate supervisory system in place to identify and provide customers with sales charge waivers to which they were entitled. We determined that, from February 2000 through July 2003, AXA earned more than $700,000 in revenue on more than $18 million invested by the customers of the firm in these two mutual fund families offering NAV transfer programs. As part of the settlement, the firm was ordered to provide full restitution to all customers who paid sales charges on purchases that were subject to these programs over a 4-year time period.

NASD is initiating a broad-based review to determine whether other firms are meeting their obligations to provide sales charge waivers to their customers under similar types of programs. Examinations and investigations are underway and NASD will bring additional enforcement actions when they are warranted.

BREAKPOINTS

As previously discussed, most mutual funds offer discounts on their front-end sales charge at certain predetermined levels of investment. These discounts are called "breakpoints." Front-end loads and breakpoints vary across fund complexes and also may vary among funds within a single fund complex. An investor usually is entitled to discounts on sales charges at investment levels of $50,000, $100,000, $250,000, and $500,000, and, typically, sales charges are eliminated at the $1,000,000 level.

Significantly, an investor usually may aggregate purchases in one or more of his own accounts and the accounts of related parties to reach a breakpoint threshold. These rights of accumulation vary from fund family to fund family. In addition, fund families typically permit investors to sign a letter of intent, which allows them to aggregate future sales over a set time period (usually 13 months) to meet breakpoint thresholds.

During routine examinations of broker-dealers by our Philadelphia District Office, NASD discovered that several broker-dealers were selling front-end load mutual funds without properly delivering breakpoint discounts to investors. We expanded our inquiry by conducting a sweep of a large number of broker-dealers of varying sizes and business models and found the same problem. Following this NASD effort, in late 2002 the SEC and New York Stock Exchange joined us for an examination sweep of 43 firms selling front-end load mutual funds. We found that most of those firms did not give investors all the breakpoint discounts they should. Failures to give the discounts did not appear to be intentional but stemmed from a variety of operational problems, including a failure to link share classes and holdings in other funds in the same fund family and a failure to link accounts of family members. As was the case in the earlier NASD-only sweep, the problem was not confined to firms of a particular type; therefore, the problem required industry-wide analysis.

Assessing and Correcting Past Performance

NASD required all broker-dealers that conducted more than a minimal amount of automated front-end load, Class A share business in 2001 or 2002 to complete an assessment of their breakpoint compliance. The assessment used a statistical sampling technique, developed in conjunction with an outside expert, to enable us to assess the universe of transactions in that time period. Approximately 625 firms completed the assessment. The assessments showed that most firms did not uniformly deliver appropriate breakpoint discounts to customers. Overall, discounts were not delivered in about one of five eligible transactions. The average amount

overcharged per transaction was $243, and ranged up to $10,000. We estimated that at least $86 million was owed to investors for 2001 and 2002 alone.

In August 2003, NASD notified broker-dealers that they were required to make appropriate refunds, plus interest, owed to their customers. In November, NASD directed almost 450 broker-dealers to notify customers who purchased Class A mutual fund shares since January 1, 1999, that they may be due refunds as a result of the firms' failure to provide breakpoint discounts. NASD directed firms to contact investors, through an NASD-drafted letter and claim form, to assure uniform treatment of investors. In addition, we supplemented that system of notification with an unprecedented NASD national advertising campaign to assure that investors were informed of their rights. We also directed about 175 of the securities firms with poor records of providing breakpoint discounts to complete a comprehensive review of transactions since the beginning of 2001 for possible missed discount opportunities.

In February 2004, the SEC and NASD announced enforcement actions against a number of firms for failure to deliver mutual fund breakpoint discounts during 2001 and 2002. The SEC and NASD each brought cases against a group of seven firms, and NASD separately brought actions against an additional eight firms. The 15 firms agreed to compensate customers for the overcharges, pay fines in an amount equal to their projected overcharges that total over $21.5 million, and undertake other corrective measures.

Correcting the Problem

At the request of the SEC, NASD, working with the Securities Industry Association and the Investment Company Institute, also led a task force on breakpoints, which included representatives from the broker-dealer and mutual fund industries, as well as academia and regulators. The Joint NASD/Industry Task Force on breakpoints was charged with recommending industry-wide changes to address errors and missed opportunities to provide discounts in the calculation of sales loads charged on the purchase of mutual fund shares that carry a front-end sales load.

The Task Force issued its report in July 2003, making recommendations that affect virtually every level of the mutual fund distribution chain, including broker-dealers that sell mutual funds, the mutual funds, and the transfer agents that administer mutual fund accounts. The Task Force made a series of recommendations for modification of the systems used by broker-dealers and mutual funds to process mutual fund transactions; additional steps by mutual funds to ensure that investors are aware of breakpoint discounts; enhancement of broker-dealer procedures to gather the necessary information from investors; and enhanced industry and investor education. The industry immediately began to implement the report's recommendations. Many of the recommendations are fully implemented and others are nearing completion. In addition, NASD, the NYSE, and the SEC will rigorously examine firms to ensure that they are meeting their responsibility to deliver breakpoint discounts.

Late Trading and Market Timing

NASD is extremely concerned about the recent revelations of illegal late trading and market timing arrangements. On September 5, 2003, we reminded the broker-dealers that they would violate NASD rules if they knowingly or recklessly effect mutual fund transactions that constitute impermissible "late trading" or facilitate market-timing or other transactions in collusion with a mutual fund that is contrary to a representation in the fund's prospectus.

INVESTIGATIONS

In September 2003, NASD sought information regarding these practices from 160 broker-dealers. Our review indicates that a number of those examined clearly received and entered mutual fund orders after U.S. markets had closed for the day. Other broker-dealers were not always able to tell with clarity whether or not they had entered late trades. This imprecision indicates poor internal controls and record keeping—issues that NASD is also pursuing.

NASD has identified a number of broker-dealers that were involved in market timing. These cases have been referred to our Enforcement Department for full investigation. A number of firms have been told that the staff believes that their market timing activities were impermissible under NASD rules or applicable Federal statutes. These firms appear to have facilitated customers' market timing strategies in mutual funds or variable annuities, employed staff who agreed with a mutual fund or variable annuity to market time the issuer's shares, or had an affiliate involved in some form of market timing of mutual funds or variable annuities. We expect to conclude these cases in the coming months and bring enforcement actions where warranted.

In February 2004, NASD announced the first of its market timing enforcement actions. NASD fined State Street Research Investment Services, Inc. (SSR) $1 million for failing to prevent market timing of State Street Research mutual funds as a result of its inadequate supervisory systems. SSR also agreed to pay more than $500,000 in restitution to the individual State Street Research mutual funds to compensate for the losses attributed to market timing activity.

NASD found that, from 2001 thorough August 2003, SSR's inadequate supervisory system improperly permitted the customers of at least one other securities firm to buy and sell shares of SSR funds alternatively, beyond the annual limits set forth in the prospectuses. SSR's supervisory procedures and systems were not adequate to prevent and detect customers circumventing restrictions designed to limit the number of exchanges made in excess of the prospectus limits.

The SSR action highlights the need for firms to follow up on red flags. While the SSR did make some efforts to prevent market timing, it did not follow through to ensure proper compliance with the measures it had put in place. Firms must respond quickly and effectively to market timing issues once they are placed on notice that such activities are occurring.

Omnibus Task Force

In November 2003, SEC Chairman Donaldson requested that NASD convene a task force to determine how omnibus processing would affect SEC efforts to curb abusive market timing trading activity in mutual funds, and in particular imposition of mandatory redemption fees for short-term trading. The mechanics of regulating market timing, and imposing redemption fees, are complicated by the fact that various broker-dealers, banks, and pension plan administrators and insurance companies use omnibus processing of mutual fund transactions, which generally does not disclose the identity of the mutual fund shareholder to the mutual fund.

Although the NASD's jurisdiction extends only to the broker-dealers involved in mutual fund sales, the SEC requested our assistance in analyzing the issue and offering suggestions as to how to achieve the SEC's objectives in an omnibus environment before it moved forward with rulemaking. The Task Force consisted of 16 professionals, who represent a broad range of participants in the omnibus trading process—broker-dealers, mutual fund sponsors, third-part administrators, banks, transfer agents, and clearing corporations. We also had discussions with a number of other interested parties who, although not members of the Task Force, were identified as having expertise, including members of the insurance and actuarial communities.

In January 2004, NASD presented the SEC with a report from the Omnibus Task Force. The Omnibus Task Force report does not reach definitive conclusions regarding omnibus processing and market timing practices; rather, it provides the Commission with an analysis of the advantages and disadvantages of various avenues for removing the economic incentives for mutual fund market timing and policies when such timing occurs. The options considered and discussed range from the disclosure of information about the underlying shareholders or their accounts to delegating compliance obligations in this area on the omnibus processor. Since the issuance of the report, the SEC has proposed a mandatory redemption fee rule, which reflects the operational pragmatics and other views offered by the Task Force.

Investor Education

Mutual funds have also been an ongoing focus of NASD's investor education efforts. In 2003 and 2004, NASD issued the following *Investor Alerts* on share classes, principal-protected funds, and breakpoint discounts: *Net Asset Value Transfers: Look Before You Leap Into Another Mutual Fund* (2/26/2004). *Mutual Fund Breakpoints: Are You Owed a Refund?* (11/03/2003). *Class B Mutual Fund Shares: Do They Make the Grade?* (06/25/2003). *Principal-Protected Funds—Security Has a Price* (03/27/2003). *Mutual Fund Breakpoints: A Break Worth Taking* (01/14/2003). *Understanding Mutual Fund Classes* (updated; 01/14/2003).

Each of these Investor Alerts educates investors about the wide variety of mutual fund fee structures that exist and urges investors to scrutinize mutual fund sales charges, fees, and expenses.

The NASD's research has shown that many investors are unaware of how much they pay to own mutual funds and that even small differences in fees can result in thousands of dollars of costs over time that could have been avoided. For example, nearly 80 percent of those responding to NASD's investor survey did not understand fully the meaning of "no load" funds.

To help investors make better decisions when purchasing mutual funds, we have unveiled an innovative mutual fund and exchange-traded fund expense analyzer on our website. Unlike other such tools, the expense analyzer allows investors to com-

pare the expenses of two funds or classes of funds at one time, tells the investor how the fees of a particular fund compare to industry averages, and highlights when investors should look for breakpoint discounts. To make this tool more widely available to investors, we developed a version of the expense analyzer for broker-dealer intranet and websites.

NASD also recently announced the creation of an Investor Education Foundation to focus our efforts on the critical area of investor education. The Foundation has been initially funded with $10 million.

Conclusion

NASD will continue its vigorous examination and enforcement focus on mutual fund advertising, the suitability of the mutual fund share classes that the broker-dealers are selling, the compensation practices between the funds and the broker-dealers, and the question of whether brokers are delivering to their customers the sales charge and pricing discounts to which they are entitled. And as we continue our examinations and investigations into late trading and market timing issues, we will enforce NASD rules with a full range of disciplinary options—which include stiff fines, restitution to customers, and the potential for suspension or expulsion from the industry. NASD will continue to work with other regulators to protect investors and restore investor confidence in this very important area of the securities markets.

RESPONSE TO WRITTEN QUESTION OF SENATOR JOHNSON FROM MARY L. SCHAPIRO

Q.1. In your oral statement, you referenced an ongoing NASD investigation of the variable annuity marketplace, and outlined several suspected abuses. Would you please describe in greater detail what abuse you suspect may be taking place, estimate the degree to which this is a problem and tell the Committee whether you believe the NASD has the authority to address the problem?

A.1. In 2003, the NASD convened a Variable Annuities Task Force (Task Force) to identify potential abusive practices and other areas of concern in the marketing and sales of variable annuities. The Task Force is chaired by the NASD Enforcement Department and includes representatives of the NASD Advertising Regulation and Investment Companies Regulation teams, the NASD Office of the General Counsel, and the Member Regulation Department.

The Task Force is charged with identifying areas of concern and approaches to addressing these concerns. Our approaches may include a wide range of initiatives, such as recommended enforcement action, investor and industry education initiatives, expanded examination content, notifications to NASD member firms and rulemaking. Set forth below is a summary of the areas of concern:

1. *Market timing in sub-accounts.* As in the case of mutual fund market timing, NASD has found instances where broker-dealers are facilitating timing in variable annuity sub-accounts (similar to mutual funds) in contravention of the funds' prospectuses or the terms of the annuity contract. Timing in sub-accounts raises the same issues as timing in mutual funds. NASD has ongoing investigations in this area. Our examiners also look for red flags that may be indicative of market timing during the course of routine examinations.

2. *Third-party or affiliated advisers used for sub-account allocation.* This involves firms selling variable products with high fees, then recommending that either third-party or affiliated investment advisers make sub-account allocations, and charging an additional layer of fees for such advice. While legal if properly disclosed, it appears that the aggregate fees could be so high as to make such recommendations unsuitable.

3. *Sale of "C share" variables.* As is sometimes the case with the sales of mutual fund "C shares," investors in these products pay substantial on-going expenses that may not be accurately disclosed.

4. *Replacement campaigns.* Registered representatives (RR's) frequently recommend that their clients switch from one variable product to another when the RR's switch firms. We believe that in many instances, these recommendations are based solely on the RR's desire to generate income with the new firm. Moreover, it appears that the firms employing these RR's may be looking the other way in the face of such activity, failing to supervise with a view to preventing unsuitable recommendations.

5. *Tax advice.* NASD is concerned that some broker-dealers are giving poor tax advice in connection with the sale of complex products. In particular, firms continue to recommend placing variable products into tax-advantaged accounts (IRA's, 401(k)'s) where the tax benefit is redundant.

6. *Marketing.* Some firms use illustrations in their marketing materials designed to highlight the advantages of the tax deferral feature of variable annuities. We are concerned that firms are using incorrect or otherwise unreasonable or unrealistic tax rate and tax bracket assumptions that distort the true difference between a tax deferred and taxable investment account. We will soon release a Member Alert to NASD member firms reminding them of the importance of using accurate tax rates in these illustrations that reasonably reflect the tax brackets of the intended recipients.

In addition to the areas of concern noted above, we are looking at other variable annuity-related issues. The first is in the anti-money laundering context. Annuity distributors face unique issues in establishing adequate antimoney laundering (AML) procedures tailored to a variable products business. For example, firms that sell variable annuities should have procedures designed to offer "free looks" and other quick surrenders of variable products (some already do, do not they?). The "free look" period is designed to give customers a very short window (often a week to 10 days) in which to change their minds before getting locked into a long-term annuity product. There is a danger that a customer could buy an annuity, surrender the product and get their money returned to them—in effect laundering money by exploiting the free look period. While this is being addressed specifically in the Task Force sweep for the firms being reviewed, it is also routinely reviewed by the NASD's examiners during all examinations of firms over which NASD has AML exam responsibility. In cases where a firm is a dual NASD and NYSE member, the NYSE may review for compliance with AML requirements.

Another issue is whether firms are complying with a rule that applies to sales in New York, called New York State Insurance Department Regulation 60. This regulation requires two meetings with customers prior to a switch. The purpose of having two meetings is to give the client a chance to rethink the transaction. NASD's New York District Offices have been investigating variable annuity replacements that violated Reg. 60. In one instance involving Prudential Securities' successor, the firm reported the problem to us and our investigation uncovered backdated and altered documents. We believe transactions in violation of Reg. 60 may be occurring at other broker-dealers as well and, as a result, NASD is investigating about a dozen firms. At this time, NASD cannot state for certain the degree to which each of the issues enumerated above is a problem. Rather, we are continuing to look at each of the issues surrounding the sales of variable annuities through the Task Force and during examinations and investigations into the targeted areas.

The issues presented by these problematic practices are serious and worthy of regulatory scrutiny. Variable products are complex securities and require a high degree of product knowledge by the firms and the RR's selling them, the supervisors at the firm who review the suitability of recommendations, and investors who consider purchasing variable products.

In April of this year, in an effort to address continuing concerns surrounding sales and exchanges of deferred variable annuities, NASD's Board of Governors proposed a rule that would impose a

wide range of requirements tailored specifically to transactions in deferred variable annuities—from new sales practice standards and supervisory requirements to increased disclosure and sales force training. In general, the rule would codify and make mandatory best-practice guidelines that NASD has previously issued. NASD intends to request public comment on the proposed rule.

Among the key requirements of the proposed rule is that RR's who recommend a deferred variable annuity transaction ensure that the customer has been informed of the annuity's unique features; the customer has a long-term investment objective; and the deferred variable annuity as a whole, and also its underlying subaccounts, are suitable for the customer, particularly with regard to risk and liquidity. The RR would be required to document these determinations.

The firm or its representative would be required to provide the customer with a current prospectus and a separate, brief, "plain English" risk disclosure document highlighting the main features of the particular variable annuity transaction. Those features would include: Liquidity issues, such as potential surrender charges and IRS' penalties; sales charges; fees (including mortality and administrative fees, investment advisory fees and charges for riders or special features); Federal tax treatment for variable annuities; any applicable State and local government premium taxes, and market risk. The risk disclosure document also would be required to inform the customer whether the variable annuity contract offers a "free look" period, during which the customer could terminate the contract without paying any surrender charges and receive a refund of his or her purchase payments.

Before an RR could effect any transaction in a deferred variable annuity, a registered principal would be required to review and approve the transaction. The registered principal would be required to consider specific factors, such as whether the customer's age or liquidity needs made a long-term investment inappropriate. Before an RR could complete a recommended transaction, the registered principal would be required to review and approve, in writing, the suitability analysis document and a separate exchange or replacement document, if the transaction involved an exchange or replacement of an existing variable annuity.

The proposed rule would require registered firms to establish and to maintain specific, written supervisory procedures reasonably designed to achieve compliance with the rule's standards.

Registered firms would be required to develop and document specific training policies or programs designed to ensure that RR's and registered principals comply with the rule's requirements and that they understand the unique features of deferred variable annuities.

Through a combination of investor education, education of sales persons recommending variable products, guidance to regulated firms about suitability of recommendations, supervision, and other areas, effective and fair rules, and thorough examination and enforcement programs, we believe that NASD, working in concert with the SEC and other regulators, have the tools necessary to address those issues and the authority to take appropriate action.

FUND OPERATIONS AND GOVERNANCE

TUESDAY, MARCH 23, 2004

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10 a.m. in room SD–538 of the Dirksen Senate Office Building, Senator Richard C. Shelby (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN RICHARD C. SHELBY

Chairman SHELBY. The hearing will come to order.

This morning, the Banking Committee holds its seventh hearing on reforming the mutual fund industry. As we continue our wide-ranging examination of the fund industry, this morning we will hear from various experts on fund operations and disclosure practices. We have assembled a diverse panel, and I look forward to hearing their recommendations and insights.

Professor Mercer Bullard is an Assistant Professor of Law at the University of Mississippi School of Law, and the President and Founder of Fund Democracy, a nonprofit membership organization that serves as an advocate and information source for mutual fund shareholders and their advisers.

Professor William Lutz is a Professor of English at Rutgers University. Professor Lutz is an expert in information design, and served as a consultant to the SEC during the compilation of the SEC's "Plain English Handbook: How to Create Clear SEC Disclosure Documents." Given Professor Lutz' expertise, I look forward to hearing his recommendations for improving investors' comprehension of disclosure documents through clear and concise disclosure.

Mr. Robert Pozen is the Non-Executive Chairman of the Massachusetts Financial Services Company and is a Visiting Professor at Harvard Law School. Mr. Pozen is also the former Vice Chairman of Fidelity Investments and President of Fidelity Management and Research Company.

Finally, the Committee will hear from Ms. Barbara Roper, who is the Director of Investor Protection for the Consumer Federation of America. Ms. Roper has served on the board of Fund Democracy and the SEC's Consumer Affairs Advisory Committee.

I thank each of you for appearing this morning and I look forward to your testimony as we proceed down this road.

All of your written testimony will be made part of the hearing record in its entirety. Professor Bullard, we will start with you. Proceed as you wish this morning.

STATEMENT OF MERCER E. BULLARD
PRESIDENT AND FOUNDER, FUND DEMOCRACY, INC.
ASSISTANT PROFESSOR OF LAW
UNIVERSITY OF MISSISSIPPI SCHOOL OF LAW

Mr. BULLARD. Thank you, Chairman Shelby and Members of the Committee for the invitation to appear here today. It is a privilege and an honor to be before the Committee, and I particularly compliment the Committee on its very careful and thorough analysis of the issues with a number of hearings in the past and perhaps a number of more to come.

The reason we are here today, of course, is that mutual funds command $7 trillion of America's retirement assets, and therefore mutual funds are at the center of retirement security for Americans. I would like to start with what my philosophy is on mutual fund regulation just so you know where I am coming from, and that is generally that whereas some investors are going to do better than others in the market as a necessary by-product of our capitalist system, as a whole what we would like investors to do is to get as much of the performance of the market as possible. That is, as a group, ideally they would achieve the entire gains of the market, but once you take away the transaction cost, the cost of investing, the cost of servicing their accounts, they are going to be left with a little bit less. What we hope to do is to leave as much of the return of the market in their pockets as possible.

The problem is that what seems to be happening is quite the opposite. A recent study by DALBAR, and I would like to make this part of the record if I may?

Chairman SHELBY. Sure, go ahead. You want that to be made part of the record?

Mr. BULLARD. Part of the record, please.

Chairman SHELBY. Yes, it will be included in the record without objection.

Mr. BULLARD. Thank you, Chairman.

In that study, DALBAR, which is an independent quantitative analysis firm, looked at the question of how much of this market have investors really achieved by investing in equity funds? From 1984 to 2003, they analyzed the S&P 500 and calculated the return on an annual basis. It was 12.22 percent. They found that the return of equity fund investors was 2.57 percent. That is 12.2——

Chairman SHELBY. Say that again. I want you to go over that. That is very important.

Mr. BULLARD. Let me make sure I have the numbers exactly right here. From 1984 to 2002 the return on the S&P 500 Index was 12.22 percent annually. The return of the average equity fund investor was 2.57 percent. That is a difference of almost 10 percentage points.

My general view is that most of that is the responsibility of those shareholders. They make bad decisions. They time the market. They invest in funds at their peak, they sell the funds at their bottom, and that is not only a problem of investor education that we also need to deal with, but it is also a problem of the way that the industry is structured and regulated. Investors are leaving too much of the market's return on the table that for the future of our retirement security we need to be in their pockets when they are

retiring. In a number of respects—and this will be the focus of my statement—this requires action by Congress. There are a number of areas, in fact the most important areas where reform is needed, where the SEC either does not have the authority to accomplish the reform or is unwilling to do so.

The first category is fund governance. In my testimony I described a mutual fund oversight board. I think we need such a board in order to do two things. One is to establish clear guidance for fund directors, that they have as a group generally complained they are lacking for decades, and also to follow up on that guidance with enforcement. It is an area where the SEC has been weakened from the standard-setting point of view. The SEC simply is not in a good position to set those kinds of detailed standards and keep them current. We need a focused, expert body that would work very closely with the industry to establish minimum standards. In addition, the SEC has not done a good job in bringing enforcement action against independent directors when they engage in misconduct. Throughout this scandal where we have had dozens of actions brought, not one has been brought against the independent directors with the possible exception of Bank of America, although it is unclear to me how the SEC could have entered into a settlement as it claims it has regarding the Bank of America directors when the settlement did not involve the fund or the directors, and involved only the fund manager, my understanding being that fund directors are supposed to be independent of the fund manager and that the fund manager does not have the authority to reach that settlement.

Another area where reform is needed to establish a fiduciary duty for directors that goes not just to the fees received by the manager, which is where it resides now, but with respect to the fund as a whole as a reasonable investment vehicle for investors. The problem with the current standard is, while it addresses the most important conflict of interest—that is between the fund manager and the fund—it does not go to the issue of whether this fund is conceivably a reasonable investment. When you have a number of funds out there with expense ratios that exceed 5 percent—there are even some that exceed 10 percent of assets—there is a crying need for some fiduciary standard to which directors will be held so that they have to ensure not necessarily that the fees received by the custodian service provider are reasonable, but the fund itself could be a reasonable investment option.

Another area is generally the independence of the board, where we need to ensure that independent directors, for example, are not former directors, officers, or employees of the adviser. It would seem obvious that those persons should be excluded from being independent directors.

That is not currently what the law states, and the SEC does not have the authority to change that view. The SEC has stated, and even proposed, that the fund chairman be independent and that the board be 75 percent independent, but that is an exaggeration of the SEC's authority for this reason. The SEC is going to, if it adopts these rules—against which there is significant opposition in the Commission itself, so it is not clear that it will even happen—the SEC is doing this by a form of bootstrapping. What it does is

it adds an independent chairman requirement and a 75 percent independent board requirement to about a dozen different exemptive rules. These are rules that the SEC has developed over the last 65 years of regulation under the Investment Company Act, and which most funds rely on and rely on importantly, in that they need to rely on those rules in order to function.

The SEC figures that since they need these rules to function, they will always have to rely on the rules, and therefore always have to have an independent chairman and 75 percent independent board. In fact, when those provisions are most needed, and that is when there is a confrontation, a difference of opinion between the fund's directors and the investment manager, the investment manager can decide at that moment to stop relying on those rules. So for example, if you have a 12b–1 plan, you are relying on Rule 12b–1. The SEC proposes to require that if you rely on that Rule, you have a 12b–1 plan, you have to have an independent chairman, 75 percent independent board, but the moment the fund manager wants to get rid of that independent chairman or has a problem with that board, it will stop relying on Rule 12b–1, cancel the 12b–1 plan, and get rid of the board. If you have any doubt as to whether that might happen, that is precisely what happened when there was a conflict between Don Yacktman, the Fund Manager, of the Yacktman Funds. He was in a conflict with the board. He engineered a proxy vote in which the board was replaced. He replaced the board with hand-picked successors, and because it no longer qualified under Rule 12b–1's independent governance provisions, he had to cancel the 12b–1 plan.

What we have now is an SEC proposal that will work in most cases but will never work where it is needed most, where there is actually a confrontation between the fund manager and the board, because the board will know that if the fund manager simply is willing to give up reliance on those rules, the requirements disappear, and in that case we do not even have a majority requirement to fall back on. All we have is that the board has to be 40 percent independent, and that is the only requirement that would apply. It can be hand-picked by the fund manager and 60 percent of the board can be fund manager executives.

The second category where legislation is needed is in the area of fee disclosure, again, where the SEC usually has the authority but has either not supported or expressly opposed——

Chairman SHELBY. Let me stop you a minute. You say fee disclosure, but you are not saying you want us to set fees, are you?

Mr. BULLARD. No. I am with the SEC on our Government really having no role to play in regulating fees.

Chairman SHELBY. It should not set fees.

Mr. BULLARD. Absolutely not.

Chairman SHELBY. But we are talking about disclosure.

Mr. BULLARD. Absolutely. And in my mind, the essence of disclosure is that, like the SEC has stated, the marketplace should regulate fees. Investors should make decisions. That marketplace is working fairly well. We have a fair amount of competition in the industry. But what we have is, and that the SEC has failed to recognize, is fee disclosure that simply is not telling the market how much it really costs to own funds. The most glaring example of that

is portfolio transaction costs. A recent study that was sponsored by the Zero Alpha Group, by a number of academics—and if I might add this as part of the record as well?

Chairman SHELBY. It will be made part of the record.

Mr. BULLARD. Thank you, Chairman.

In this study a couple of academics looked at the question of how much are these portfolio transaction costs. Let us just start by looking at the commissions, the dollar amount paid, and to see whether it really has an impact, and then we will do a reasonable estimate of spread cost. Spread cost is the difference between if there is a buy price and a sell price, it is the difference that you would pay. I find the best way to imagine it is to imagine that you were buying and selling the same amount of stock at the same time. You would think that you would break even, but you will not. The difference is that you are going to buy at the high price and you are going to sell at the low price in that spread. Just including those two components of portfolio transaction costs, they found that the average equity funds portfolio transaction costs equaled 43 percent of their expense ratio, which I call the partial expense ratio because any time you have an expense ratio that leaves out 43 percent of the cost, that is not something that is representative of what it costs to own the funds. Rather, I consider that to be a misleading number.

If you look at the last page of my written testimony, I included a chart from their study in which they show—and this is only for funds that have more than $100 million in assets. These are not outliers. A couple of funds, for example, the PBHG Large Cap Fund expense ratio—and this is what the SEC is telling us this fund costs—is 1.16 percent. What the study shows us is there are an additional 4.27 percent of assets spent on commissions, another 3.16 percent spent on spread, so that the total actual expenses, just including those two components of portfolio transaction costs, is more than seven times what the SEC is telling us this fund costs. This is misleading because it does not punish fund managers for behavior that the market may consider important.

I am not saying anything about whether they should be allowed to do the frequent trading that causes these costs. The market should make that decision. But what the SEC has done is said, we are going to make the decision for the market. We are going to give the market a partial expense ratio. That is the only standardized figure we are going to give the market, and we are not going to let the market have another standardized figure so it can choose. I say let the market choose which is the number that they think is the best reflection of costs, and leave it at that. Thus far the SEC has been flatly opposed to that approach.

The second area that the SEC has opposed disclosure is the actual disclosure of individual shareholder costs in their statements. This was a proposal they specifically rejected in a recent rulemaking. Ironically, just last week, MFS—and I am sure Chairman Pozen can talk about that—has proposed to provide precisely the disclosure the SEC rejected in quarterly statements to its shareholders. This is a shocking development.

Chairman SHELBY. Explain how that would work if the SEC had adopted it.

Mr. BULLARD. What I would have had the SEC do is two things. One is you have to tell the shareholder either exactly what they paid or a pretty good estimate of what they paid so it is an individualized number, and the second thing is it has to be on their statement. That is exactly what MFS is doing.

Chairman SHELBY. And should be in plain English. We will get into that in a few minutes.

Mr. BULLARD. Absolutely. And of course, what Professor Lutz has worked up is an excellent analysis of the issue of what your broker got paid, and it is the confirm disclosure. This would be on the statement, and the reason that it is important that it be on the statement is that what we are trying to do is reach investors who are currently not price sensitive. We are trying to affect a part of the market by putting a number in front of them—and again, let the market decide—but put it in a place where they are actually going to read it. The average investor, including probably most of the people in this room, take their shareholder report, and it goes right from the mailbox into the trash. What everybody in this room does, however, is you open your statements, look at them, see the value of your account, and you feel great if it went up that quarter and you feel bad it went down that quarter. But what you would also be informed by would be the dollar amount what it cost you to pay that manager to be in that fund, right on that statement. You cannot overload it with a lot of things. I do not think you should do much more if anything than tell the person what the value of their account is and what it costs to be in that account.

What the SEC has decided instead is to give you a hypothetical number, which is not the number that you paid, and to put it in the shareholder's statement.

Chairman SHELBY. Why would they want to do that?

Mr. BULLARD. For two reasons. One is the cost which the industry said was prohibitive. I imagine Mr. Pozen would have some comments about how MFS is going to be able to afford this prohibitive cost since they have now decided to do precisely the same thing. The other reason was they thought it might be misleading. Apparently Mr. Pozen also believes that it is not misleading. Now that those two arguments seem to have been washed away by——

Chairman SHELBY. If it is misleading, although it might cost more, truth should trump that, should it not?

Mr. BULLARD. I take a very economic view of this business. Truth should trump that, and the net cost should be exceeded by the benefits. If you could show me that this disclosure in the statements would not mean that investors will save more money because of increased competition, I would be opposed to that disclosure. The test has to be that the benefit has to exceed the cost because ultimately the mutual fund industry is about creating wealth for Americans across the board and keeping as much of the market return as possible.

The other areas where the SEC has opposed disclosure would be putting those fees in context, having disclosure like they have for performance in the prospectus, that shows you that your expense ratio for this fund is 1.2 percent and the average of your peers is, let us say, 1.4 percent, and what you would pay to be an index fund, that is, what you are paying to choose to have your money

managed rather than have it simply by the market is let us say 0.2 percent. So, people can really see the decision they are making, and again, you let the market decide by forcing standardization, which is really where the Government can intrude and can promote efficiency and competition without having any decisionmaking authority as to what people should pay.

An area regarding fee disclosure is the distribution expenses. Currently, the SEC requires that the fee table have a line item that says "Distribution." That is the 12b–1 fee. In fact, there are distribution costs that are being paid out of the management fee. So what you have is a group of shareholders who use 12b–1 fees as a cut-off, as a screen, thinking that if I do not want to buy a fund that is spending money on distribution, I will simply ignore the ones that charge a 12b–1 fee. And, nothing could be further from the truth. In fact, you could have two funds, one charges a 12b–1 fee and one does not, and the amount that that shareholder is effectively spending on distribution is the same in both cases.

The area where the SEC does not have authority in this case is soft dollars, and I have reached the point where I would support a ban on soft dollars. The problems with soft dollars have been well-studied. They are essentially twofold. One is that you have fund managers spending other people's money on something that they would otherwise pay for out of their own pockets, and that was well-illustrated in a couple of *Wall Street Journal* articles last week in which both MFS's plans and Fidelity's requests of the SEC include a discussion of how much of their commissions they estimate are actually being spent on things they would otherwise pay for out of their own pockets. MFS has proposed to ban soft dollars. Vanguard has always shunned soft dollars. American Century has always severely restricted soft dollars. Putnam is now severely restricting soft dollars and is considering banning soft dollars.

The problem with each of these positions is that Mr. Pozen's shareholders are going to be asking him, why is it you are still paying 5 cents a share and the price has not gone down, yet you are spending more of the fund manager's money on these reports because you are not willing to buy them with that 5 cents a share? I believe—Mr. Pozen may disagree for business reasons—but I believe he is going to be under some pressure competitively because it is going to put him at a disadvantage because other fund managers are going to be spending the fund's money on those reports that are coming out of MFS's pocket. I am saying you have to have a level playing field for this to work, and we begin with a ban.

But if we do not have a ban, the least we could do is either severely restrict soft dollars so that they pay only for reports that represent an opinion about an issuer's value, or we restrict them in the sense that Fidelity has proposed, in that we should completely unbundle the transaction and require that there be an objective value assigned to all the nonexecution components, or at an absolute minimum, let the market know what soft dollars is costing us. The reason the market does not know goes back to the portfolio transaction cost problem. It is not in the expense ratio. So at a minimum, let the market decide if it wants to allow this practice to continue, then let people know what the cost of it is and let them decide for themselves, and I would say that would be at the top of

my list as to how to deal with soft dollars, but there are a lot of different approaches, none of which the SEC seems to support.

Another area where Congress needs to act is in the reform of distribution costs. Congress, in 1940, wisely enacted Section 12b of the Investment Company Act. The effect of that provision was essentially to prevent funds from underwriting their own securities, that is, being in the business of distributing their own shares. The reason for that was that Congress was concerned that fund managers would simply spend the fund's money to sell more shares in order to increase the fund manager's advisory fee.

The SEC opposed for years any exception to that standard. They finally relented, as we all know, with Rule 12b–1 in 1980. Initially that was intended to allow simply marketing expenditures, and it was designed to deal with periods of net redemptions when the industry was actually losing assets and it needed a competitive temporary boost. The SEC never anticipated what has happened today, which is now those costs represent, based on ICI statistics, only 5 percent of what 12b–1 fees go to. Sixty-three percent of 12b–1 fees go for a purpose that was never intended by the SEC and is flatly contrary to Section 12b, and that is to compensation for brokers. The problem with that structure is essentially you have brokers being paid by the product to sell the product, so that instead of selling the best product and being compensated on the basis of a successful relationship with their clients, the broker is getting compensated based on which fund complex he can pressure the most payments out of, and you have a system where the brokers' interests are not aligned with shareholders' interests because the broker is pushing the fund manager which pays the highest fees to the broker. So what 12b–1 has done is essentially it has tied the compensation of the fund manager with the compensation of the broker, whereas the broker's compensation should be tied to the relationship to the customer.

What Congress needs to do is to set things back the way they were in Section 12b in 1940 and prohibit fund managers and prohibit funds from paying brokers in connection with selling fund shares. That is an important distinction. I do not think there is a problem with funds or fund managers paying to market the funds. A classic example would be running ads in *Money Magazine*. That is generally where you have a reasonable alignment of interest between the fund manager and the fund. It is something that the directors could oversee and they should be expressly required to do so. But the fund should not be paying for the relationship between the customer and the broker, and neither should the fund manager. That requires outlawing revenue sharing, also known as shelf-space payments, and that would require repealing 12b–1, since for 24 years the SEC has been unwilling to take any action on this, even though it has repeatedly promised to reform 12b–1 fees.

I note that it recently proposed some changes to 12b–1 to ban directed brokerage, and once again it has missed the opportunity to accomplish real reform and return 12b–1 to what everyone on the Commission and on the staff admits is a purpose for which it was originally intended.

Finally, the last area where we really need Congressional action is in fund names, and I think this is an issue that will strike home

for this Committee especially, in that the SEC has stated that funds can use the term "U.S. Government" in their names, that they can invest fully 100 percent of their assets in Government Sponsored Enterprises. That means that a fund can say, I am a U.S. Government fund, and I am going to address 100 percent of my assets in Fannie Maes. My view is that your average American expects a U.S. Government fund to invest in creditworthy instruments, and what we are learning every day, more and more, is that Fannie Maes are not as creditworthy as we thought. They are not guaranteed by the Government. It is inherently misleading that any U.S. Government funds invest more than the legal limit normally required by your name, and the SEC has expressly refused to take that position.

I applaud the SEC for the steps that it has taken. The Division of Investment Management has accomplished more good rulemaking in the last 6 months than it has probably in its history, but again, even though they are dealing with important aspects of the ongoing scandal, they do not go to the most significant problem facing the industry, and that is with the market over 19 years returning 12.22 percent and investors receiving only 2.57 percent, there is something wrong with the system, and the primary problem with the system is that fees are not being disclosed in a way where people are making rationale decisions. To a large extent, that is their own fault. We need to educate people to make better informed decisions, but we also have a responsibility for putting out an expense ratio that we say is the total cost of the funds but is not actually representing those costs.

My number one priority would be each of the fee disclosure issues that I have laid out for the Committee before any other, because my view is we should look to the market and look to the market first, and we have to give the market the tools to make efficient decisions.

Thank you again for the opportunity to appear here today. I will be happy to take any questions.

Chairman SHELBY. Thank you.

Professor Lutz.

STATEMENT OF WILLIAM D. LUTZ, PH.D., J.D. PROFESSOR OF ENGLISH, RUTGERS UNIVERSITY

Mr. LUTZ. Thank you for the invitation, Chairman Shelby.

I have rewritten about 58 mutual fund prospectuses into plain language, at least as far as I was allowed to write them into plain language. I can remember the first time I ran into the turnover rate, which was always buried in the back of the prospectus, and asking what that was.

Chairman SHELBY. When you were rewriting them—excuse me—were you getting all the ambiguity out of them, much as you could?

Mr. LUTZ. As far as I was allowed to. There was a strict adherence to the SEC regulations, no more, no less. What I wanted to do more to explain more, for example, the churn rate or the turnover rate, or in that wonderful phrase "portfolio transactions cost," which I have absolutely no idea what that means to any normal human being who does not have a CPA.

Chairman SHELBY. Say that again?

Mr. LUTZ. Portfolio transaction cost. It makes one's eyes tend to glaze over.

Chairman SHELBY. Portfolio transaction cost. What does that really mean in plain English?

Mr. LUTZ. In plain English, it means when you are buying and selling the assets in the fund you have to pay for that, and that is what you are paying for, all the costs that are associated with that. But you have collapsed a lot of costs into that phrase and you have made a wonderful abstraction, the kind of abstraction that people do not question because they do not want to appear to be stupid or uninformed.

Chairman SHELBY. Do they bundle these costs together for the reasons not to disclose in a sense?

Mr. LUTZ. Oh, of course. George Orwell said, "the great enemy of clear language is insincerity."

Chairman SHELBY. Funneling, is it not, funneling too? You put them all together and you do not know what is what.

Mr. LUTZ. One big ball of wax and one big ball of twine that you have to try and unwind.

I was always impressed by the mutual fund industry—and there are a lot of people who can do this—but I was particularly impressed by the number of synonyms they found for the word "fee."

[Laughter.]

Chairman SHELBY. Take your time. Go ahead.

Mr. LUTZ. My apologies to Gertrude Stein, but a fee is a fee is a fee. It is money out of my pocket. When I bought my house and I went through all those lists of settlement fees, and all I knew was there was a bottom line and I had to write that check.

Chairman SHELBY. But they were broken down.

Mr. LUTZ. But they were broken down. I knew exactly how much I was paying for the residual fuel oil in that heating tank of the house I was buying and the sewage bill and the water. It was all broken out so that I could question things if I had any questions.

There is no comparable effort in a mutual fund prospectus. There could be, no trouble at all, easily done if you want to do it. I think there is an important word here and it goes with an important phrase. The first word is transparency. The strength of the American financial markets is transparency because nobody gives money to somebody if they do not know what is going on. And second, disclosure is not disclosure if it does not communicate. To simply give data is not to communicate. To say the portfolio transactions costs are $150 tells me nothing, absolutely nothing. There is no information there, and it is the job of the people putting this prospectus together to give information, to explain things, to create a context. What does this cost? Why is it going to affect my investment?

I agree with Professor Bullard. The idea of doing this hypothetical $10,000 investment, and we would draw the charts, means absolutely nothing to anybody. It certainly did not mean anything to us. In fact, I do not think anybody knew, at least any investor knew where those numbers came from or what they meant. The question always is, what does that mean to me and my investment?

In an age of computers—and I am not a computer expert, but I have seen enough that can be done with them—to say we cannot do individualized reports I find mystifying at best. My investment

through the University is with TIAA–CREF, and each quarter I get a detailed breakdown of all my investments.

Chairman SHELBY. Banks give you a monthly statement.

Mr. LUTZ. My checking account, my savings account, and in fact, if anything, we are flooded with data. Computers can grind out more data than any human being could ever assimilate, but we are not talking about information. To simply give numbers to investors does not say anything. We have to tell them what the numbers mean and how the numbers affect them.

In the appendix to my statement that I submitted in the redesigned form of the confirmation of sale, we tried to take that data and make sense out of it to the person who is buying these shares. We wanted to say, okay, what is this going to cost me, bottom line? How much is it going to cost me while I hold these mutual fund shares? Is it going to cost me anything when I sell them? Just give me these numbers. So if I am investing $1,000, but I find out that over $300 of this $1,000 is going to various sales fees, I might want to think about that. I might want to look for another fund that says, hey, we only charge $150. I am a terrific believer in competition, but you cannot have competition when all the guys are hiding the information from you. Then it does not work.

Chairman SHELBY. But it would enable the consumer, the fund holder, the people that buy $7 trillion, have invested everything, to make an informed decision, is that correct, for the market?

Mr. LUTZ. Exactly. I drive down the street and I can choose which gasoline station I am going to because they post their prices. There is nothing hidden there, and I know what those numbers mean. But when I go to look for a mutual fund in which I might want to invest, I am swamped with meaningless data, and if anybody in this room suffers from insomnia, let me suggest simply picking up a statement of additional information, and by page 8, I guarantee you will cure your insomnia, even though that statement may run over 100 pages long of 8-point type, single-spaced, no indentations. It is designed to put you to sleep.

I am mystified—I guess I am not, I am not that innocent. This is done deliberately. Because one of the things we discovered on the Plain Language Project at the SEC is that the sales materials for mutual funds, the pamphlets, the brochures that they put out, were magnificent in design, communication, clarity, graphics information, and you would turn around and look at the other information in the prospectus and it was exactly the opposite. There was not anything there to explain things to you, and in all of the investor information given to you once you were a shareholder.

Chairman SHELBY. You might be going to get into this. Maybe I am getting ahead of you. What is the average financial literacy? In other words, rate of the average American, the average investor. It seems to me that a lot of stuff that we get in the mail you would either have to be an investment banker, an analyst, a securities lawyer, or somebody that was dealing with this to understand what was coming to you.

Mr. LUTZ. You have two issues. The first is readability, that is the reading level. You should be at a seventh grade reading level to have a reasonable chance of having a significant amount of the population to understand your materials, and in fact, if you want

to guarantee wide readability you would have to aim for the fifth grade level. On the SEC proposed forms on one readability study I did, the lowest grade level I got was 12.5. The highest I got was 15, which means that all you needed was a high school diploma and 3 years of college and you would have a 50-percent chance of understanding this document.

The second is financial literacy, and numerous studies have been done to show that that is extremely low. The Department of Education also does a literacy study, which it updates regularly, and it is a detailed and magnificence study. They found that less than 10 percent of the people in that study—and this is a representative sample—could not read and interpret a bar chart. Only about 30 percent—I think it was around 28 percent—could read and interpret a simply age and weight chart for determining the amount of medication to give to a child. You had to find the age on one side and on the top the weight, draw the two lines together. When it comes to literacy, financial literacy, it is much, much lower being able to interpret this kind of technical data. It is really incumbent on us who provide information to do our best to use information designed plain language to communicate as clearly and as simply as possible. It can be done. It has been done, and it is done regularly if you want to do it.

One of the main points in my statement is that the Securities and Exchange Commission has to incorporate this into all of their procedures. Document design, information design, should just be automatic and standard. It is in a number of Federal agencies already. The Social Security Administration has done extensive work. The Veterans Benefits Administration has found that they saved a huge amount of money by redesigning their forms to make them understandable to the recipients. So, we are not talking about anything new. We are talking about not just money. We are talking about retirement, your future life, your children's college education. You are talking about the quality of how people will live. Will they be able to retire? This is more than money. It goes to the very heart of the quality of our lives.

Transparency is important because it leaves to confidence that we have the information we need, and when we have confidence we trust, and if we trust, we invest. If we do not trust, we draw back, as we have seen recently. My theory is that there will be a great distrust of mutual funds, and once trust is lost it is very difficult to get back, no matter how hard you try.

Chairman SHELBY. Thank you.

Mr. Pozen.

STATEMENT OF ROBERT C. POZEN
CHAIRMAN, MFS INVESTMENT MANAGEMENT
VISITING PROFESSOR, HARVARD LAW SCHOOL

Mr. POZEN. Thank you, Chairman Shelby and Ranking Member Sarbanes.

I know that you have been holding these important hearings on the broad subject of mutual fund reform, but today I would like to concentrate on three areas, one having to do with brokerage commissions, which the professors already started to address; another individualized reporting which has also been discussed; and finally,

fund governance. Then I would like to add just a few comments on 12b–1 fees.

Beginning with brokerage commissions, we at MFS want to reduce the brokerage commissions that are paid by the fund shareholders, but it is now very difficult to negotiate for a lower price on commissions because the system is not transparent. If a mutual fund has a large trade, for example, a 500,000 share order in a stock like Genzyme, you will need to go to a full service broker to get a good execution. A trade this big would not be easily executable through electronic networks because they do not handle that sort of volume. You might need capital on the desk, you need a much higher level of skill. Such a trade cannot easily be done through a passive facility. If you go to any full service broker on the street, it will charge you 5 cents a share and it is very hard to get a lower price. But full-service firms are very willing to give all types of what I call in-kind discounts. If you want to, they will forward some of the commission to pay for third-party research. If you want to, they will forward some of the commission to Bloomberg and provide you with a Bloomberg terminal. If you want to, they may even pay your rent. So there clearly is a system by which there are noncash items that are being paid for by soft dollars, and these items are not very easy to separate from the overall price of the commission.

MFS announced last week that we will be paying cash out of our own pocket for third-party research and certain types of market data, and we hope to get a lower price on the commission, but we need help. MFS alone is not going to change the pricing structure on Wall Street.

As mentioned before, there are some firms like 20th Century that are moving in this direction or already have moved, but we need many mutual fund companies to move in this direction. We also need the help of the SEC.

In 1975, Congress passed a safe harbor for soft dollars in Section 28(e) of the 1934 Act. Early on the SEC had a rather strict and narrow interpretation of that safe harbor, saying you could only use soft dollars when the good or service was not readily available for cash. But then in 1986, the Commission vastly expanded the safe harbor by saying essentially that you could use soft dollars for any "legitimate use," and this has led to a widespread proliferation of soft dollars.

What I am proposing is fairly simple. I think we should go back to the stricter definition that the SEC originally had, and that will constrain soft dollars.

Chairman SHELBY. What was that? What was the stricter——

Mr. POZEN. The stricter definition was you can only use soft dollars if the good or service is not readily available for cash. In that case you could not have somebody paying for your Bloombergs, you could not have somebody paying your rent, you could not have a lot of things that go on.

Chairman SHELBY. Senator Sarbanes has a question.

Senator SARBANES. What is the rationale for having it at all?

Mr. POZEN. I would say we do not know how the system would work without any safe harbor, and I would like to see from an evolutionary point of view how it would work out with a narrow safe

harbor, so the rationale is both a preference for an experiential approach, and second of all, that in all industries there is some bundling, there are things that are put together, and I think the key is to understand what the bundles are composed of. We are very much supportive of the value of research. I was misquoted in *The New York Times* about a week ago on that. But the question is, what research is exactly being provided as part of that commission? The SEC has proposed an itemization or a better accounting of the components of the commission. I have no problem if I am buying a 3-cent execution and I am paying one penny more for access to a very well-trained and very good set of researchers. I just want to know what I am paying for. If research and execution are bundled together, you could argue this is no different than the fact that when you buy a computer, you also get software.

Chairman SHELBY. Sir, how can you know what you are paying for if it is all intertwined?

Mr. POZEN. Now, it is intertwined. That is why I support the SEC's concept release where they would itemize the elements and so we would know what they are. But that is very different than saying if you know what the elements are, then you cannot buy a bundle. In order to allow the industry to continue buying bundles of products, you probably do need the safe harbor in Section 28(e).

I am just explaining that there are two very different questions. One is, should there be an itemized breakdown of the commissions? And I strongly agree. I also feel that the SEC should have a much stricter definition of 28(e). But I would not answer yes to the second question—should we push for the repeal of 28(e)? If we knew the prices of all the items included in the commission and the SEC adopted a stricter interpretation of 28(e), I believe we could have a transparent negotiation, and some of the services might be bundled with others, as long as we know what we are getting, which we do not now.

Chairman SHELBY. But any market works more efficiently when people know what the cost of this is and where it is out there, as Professor Lutz says, "in plain English." Otherwise you are guessing. It is ambiguous.

Mr. POZEN. Here we are talking about the disclosure by the Wall Street firms as to what are the components of the full-service commission. As I said, I strongly support the proposal to have an accounting of those items so that we can see what the items are. But I am just trying to say that is a very different question than if you understand all the items, can you buy two services together?

Chairman SHELBY. But you will never understand them if they are not itemized, will you?

Mr. POZEN. I agree with that.

Chairman SHELBY. You will never know, just like Professor Bullard referenced. Go ahead.

Mr. POZEN. I would also advocate in the semi-annual and annual reports that there be an average commission per share that is disclosed, but I would be against putting brokerage commissions into the expense ratio for two reasons. One is, brokerage commissions are treated for both accounting and tax purposes as a capitalized expense, and all the other expenses in the ratio are ordinary expenses. By capitalized expense, I mean that it goes to the basis, the

tax basis of the security. So if you buy a security for $10 and you pay 5 cents a share, then its basis is $10.05, and when you go to sell it, you subtract the $10.05. So, you are really mixing apples and oranges.

Chairman SHELBY. But it is still an expense.

Mr. POZEN. I believe it should be disclosed as a separate average commission per share. But I am saying if we put brokerage commissions in the expense table, we create the sense that it is the same expense as management fees and transfer agency fees; it is not the same expense.

Chairman SHELBY. It might be apples as opposed to oranges, but it is still fruit, is it not?

Mr. POZEN. It is fruit, and we definitely need to have disclosures about brokerage commissions. All I am saying is that it should probably be right below the expense table, but should not be in the expense table.

The other thing is that commission prices are only one element of brokerage costs. You also have spreads, and spreads are extremely difficult to compute. I do not know how anyone would be able to say the exact amount of spread that had been paid. So, I am all for the disclosure of the average commission per share that the fund pays, but I think that we should be careful to understand that it is a very different expense than the other expenses in the expense table and should be broken out separately.

On the question of expense reporting, I think we should understand that there has been an effort over the past decade to have expense reporting in the prospectus. There is a fee table with the advisory fee, the transfer agency fee, the 12b–1 fee, and other fees. I think the problem is that these are expressed in basis points which most people have a hard time understanding.

Chairman SHELBY. Excuse me. But they could change that. You could have a little formula there, saying 10 basis points equals so-and-so, or 5 basis points, rather than just basis points.

Mr. POZEN. I agree, and the hypothetical, the $10,000 hypothetical is there to try to give you an actual dollar amount, but still, it is a hypothetical. What we are doing at MFS is to provide for every shareholder in the quarterly report the estimated dollar expense of their expenses in each of their funds.

There has been a large debate about whether or not this is too expensive for the industry, and if you really tried to get the actual expenses of every single shareholder and every single fund, it would be in fact a very large computer programming project and would cost a lot of money. But what we have done is made two simplifying assumptions which are quite reasonable and give you a very good estimate. The first assumption is that at the end of the quarter we look and see what funds you hold, and then we assume that you have held them for the full quarter. We do not assume that, for instance, you came in on January 21 and came out on March 21. That assumption makes it a lot easier. In fact, by making that assumption, we might be overstating a little your fund expenses because if you came in on January 21, we are actually giving you what you would have paid during the full quarter.

We are also making a second simplifying assumption that you are reinvesting your dividends, which most shareholders do. So

with those two simplifying assumptions, which are applicable to over 90 percent of our shareholder base, we are able to provide later this year an estimated dollar amount of the expenses for each shareholder for each of the funds that he or she holds at the end of the quarter. I think this is a case in which the best is the enemy of the good. We can give a good estimate. It is not perfect. We can do it at a reasonable cost. If we try to have the perfect number, the exact number per shareholder, then we are imposing these large computer programming costs, which I think are unnecessary because I think we can get a very good estimate that is applicable to most shareholders through such assumptions.

I also wanted to talk about fund governance, and here again MFS is leading the way. We already have over 75 percent independent directors and we have independent co-chairmen of the funds drawn from the independent directors. But I have to say in this debate about whether you should have an independent chairman or an independent lead director, I think it has become a little symbolic. The question from my point of view is, do you have a senior independent director who is playing the functional roles that you need? Among these functional roles, the most important are first to have an executive session of the independent directors in which management is not there, where they can have a discussion about issues. And you need a senior independent director to lead that. Second, you need a senior independent director to work with management to help set the agenda for the board meetings. If you have such a senior independent director playing those two functions, in my view it is not so important whether that person is called a chairman or a senior lead director. The key is to have the functions played, and if those functions are played, it seems to me it is okay to have them called in some complexes "chairman" and in other complexes "senior lead directors." The key point is to have the functions played.

Another aspect of fund governance is to have outside advice for the independent directors that is really their own advice. Most complexes, as MFS, have outside counsel to the independent directors, and that outside counsel is an independent firm. At MFS, we have gone one step further and we will have an outside compliance monitor who works for the independent directors and who will monitor the compliance activity of management.

Of course, we on the management side have our own compliance director, but this will serve as an additional check and balance.

On the management side of MFS we have my position, which is a new position, the Non-Executive Chairman of the management company who reports directly to the fund directors. We also have a second new position, an Executive VP for Regulatory Affairs, which shows how important we think those issues are, and that person is now a member of the management committee, the executive committee of the management company.

However, I have heard various proposals on governance that I would respectfully disagree with. Some of these proposals involve establishing an SRO for mutual funds. Some of them involve having a special board to provide guidelines to directors. I personally am in favor of a flat organizational structure. I think it is best when people are getting the word from the real authority. I believe

that the key is to have an effective Investment Management Division at the SEC, to strengthen it, and to give it more personnel if necessary. SEC officials are the ones who should be dealing directly with the regulation of the industry, and they are the ones who should also be giving guidelines to directors if guidelines are appropriate. So, I would urge the Committee to take the approach of giving the SEC more resources, which I know has been done, rather than to create these intermediate boards or bodies which I believe would not be particularly helpful.

The last question, on which I had not intended to testify, but since it was brought up, I will mention it involves 12b–1 fees. Here I would strongly agree with the people who say we need better disclosure at the point of sale. When the broker or representative is presenting these issues to the customer, the customer needs to understand if there are 12b–1 fees and how much they are paying in addition to the other fees. The SEC has a proposal now for better point-of-sale disclosure. I think it is a step in the right direction. And it is quite a good proposal. Obviously there are aspects of it that people will debate.

But I am strongly against the elimination of 12b–1 fees, because 12b–1 fees are essentially an installment payment plan for a sales load. It used to be the case that we had sales loads of 8 percent up front. Then 12b–1 fees were allowed by the SEC. The historical origins of 12b–1 are quite complex, and people can debate historically what its original intent was. But now it serves as an installment sale plan, so instead of paying 8 percent up front or 6 percent up front, you pay a certain amount each year for a certain number of years. In my view, people should have the choice. They should have the choice between an up front payment and an installment sale over a number of years. But the key point is that they understand the difference and they understand what they are signing up for. If they know that they are signing up in one instance for a front-end load and in another instance for an installment plan with a certain amount of payments each year, then that is a reasonable choice. If we do not have good point-of-sale disclosure, then we are not building a good system.

I think it would be a big mistake to eliminate 12b–1 fees and eliminate the choice of an installment sale plan for many people who want that plan.

I think I am going to end there and leave the floor for Ms. Roper.

Chairman SHELBY. Thank you.

Ms. Roper.

STATEMENT OF BARBARA ROPER
DIRECTOR, INVESTOR PROTECTION
CONSUMER FEDERATION OF AMERICA

Ms. ROPER. Thank you very much. Thank you, Chairman Shelby and Senator Sarbanes for holding this hearing today and for inviting me to testify.

When I prepared for my testimony today, I thought it was a good opportunity to look back at what has been done at the SEC since the mutual fund scandals first hit. I would like to say at the outset that we at CFA think that the SEC has done a very good job in recent months of developing a strong and credible mutual fund re-

form program. Although the Agency may have been caught off guard initially by the mutual fund scandals, it seems now to be acting aggressively in all three areas of its responsibility—enforcement, oversight, and regulatory policy.

It is on that issue of regulatory policy that CFA has primarily focused its attention. Last November we, along with Fund Democracy and several other national consumer groups, released a blueprint for mutual fund reform, outlining the steps we believed were necessary to restore badly shaken investor confidence and the integrity of the mutual fund industry. When I prepared my testimony today, I went back to that blueprint to see what we had recommended, what the SEC has since done, and what we believe remains to be done by Congress or by the SEC to achieve that agenda. My written statement goes point by point through the blueprint and analyzes those issues.

Chairman SHELBY. Could you touch on those just a minute?

Ms. ROPER. There are probably 30 recommendations in the blueprint, but, yes, I will look at that. When you look at what the SEC has done, it is a preliminary assessment at this point. Most of what they have proposed is either in the rule proposal or concept release stage on the key issues, and we do not know for sure what the final rules will look like. In some cases, particularly like the point of sale and confirmation disclosure, we are very supportive of the thrust of what the SEC is trying to do, but believe significant amendments are needed to realize the potential of those reforms. We believe Professor Lutz has some very helpful suggestions. We do not know whether those changes will be adopted, so we do not know what this program will look like 6 months from now. What is really rather remarkable, when you go back and perform this exercise, is how much of the policy that we suggested in the blueprint in November has since been taken up by the SEC. So in areas that have to do with how you specifically address the trading scandals or how you deal with broker-dealer sales abuses or how you deal with oversight of mutual funds, most of what we have suggested has since been either proposed or adopted by the SEC.

Despite that important progress, we see some areas where we think there is still a need for legislation. Some of those are the result of the SEC's lack of authority to act, or lack of authority to adopt reforms that we believe are needed. Some of them are areas where the SEC would appear to have the authority but simply has not taken the actions that we think are necessary to adopt important investor protections. So while we do not necessarily see the need for sweeping legislation, the mutual fund equivalent of the Sarbanes–Oxley Act, we do still believe that there is a need for a narrower bill targeted at some specific issues.

At the top of our list of those issues is one that we have discussed a lot this morning, and that is mutual fund cost disclosure. It has for us been the one big disappointment in the SEC's response that they have not proposed the innovative presale cost disclosure for mutual funds that we believe is necessary to provide real effective market discipline of mutual fund costs. I am going to leave aside the point on portfolio transaction costs. I agree with the statements that Mercer has made, that if we are going to provide cost disclosure information, it needs to be complete cost disclosure.

We need to be covering the costs in a way that does not create a misleading impression about the affordability of that fund.

That said, I think that the current system works reasonably well for a portion of the investing public—those people who either have the sophistication themselves to find the relevant information and use it to make cost conscious decisions and buy high-quality, low-cost funds, and those people who have objective advisers who are helping to steer them into those high-quality, low-cost funds. But we also know that there are a lot of low-quality, high-cost funds that are able to survive and even thrive in this marketplace. And the question is why? I think ineffective boards is part of the answer. I think reverse competition in the broker sold market is part of the answer. But I think a major part of the answer is that we are not giving unsophisticated average investors the type of cost information they need to make good purchase decisions.

The way we assess disclosure is, does it provide the information you need at a time when it is useful to you in making your purchase decision and in a form you can understand and that encourages you to act on that information? I would say that the current cost disclosure on mutual funds fails all three of those tests.

The SEC's recently adopted rule on cost disclosures, putting this information in the shareholder report, in my view, simply fine tunes the system for the people for whom it is already working reasonably well. It does not do much to help ensure that the investors who are not well-served by the current system are now going to get the information they need in a form they can understand at a time when it is useful to them.

So, we would certainly like to see this Committee take up the issue of improved mutual fund cost disclosure. Because you can bring down costs a fairly modest amount, and add billions of dollars to the retirement and other savings of working Americans.

The goal should be to look at how we are going to make the system work for the people for whom it does not work now—for the people who are buying high-cost, low-quality funds, and the average unsophisticated investors who are most in need of controlling their costs and least likely to do so now.

To do that, in very general terms, we would like to see you adopt legislation that requires presale disclosure of comparative cost information for mutual funds in plain English, in a document that is accessible to average investors, that is tested in advance for its readability and usability by average investors. And we would also like to see mandatory disclosure along the lines that MFS is now providing on account statements of estimated actual costs for shareholders.

We know investors look at their account statements. It is a document that we believe is an effective place to provide cost information. It is not as good as presale disclosure, because it comes after the purchase has been made. But at least it provides an opportunity to make investors much more aware of the impact of costs and to maybe encourage them to make more informed decisions in the future.

We believe that approach combined with the fund governance reforms proposed by the SEC—and we would like to see those enhanced in certain ways, creating a broader fiduciary duty along the

lines that Professor Bullard has recommended—we believe that those steps could go a long way toward wringing out excess costs from the mutual fund industry, enhancing the retirement savings of average Americans, and doing that without any need to set costs or impose costs. Let the market discipline costs. But for the market to discipline costs, we have to have an effective system of disclosure, which we do not have now.

And then quickly looking beyond the cost issue, there are several areas where we believe the SEC needs enhanced authority to act—where we believe they may have the will to adopt reforms, but not the ability. One of those that we think is very important is in the issue of the independent governance requirements. We believe that the SEC needs to be able to apply those reforms directly, not rely on the exemptive rule process. We believe they need the ability to strengthen the definition of what constitutes an independent director so that your uncle or someone who retired 2 years ago from the fund manager cannot serve as an independent director. And, as I said, we would like to see the fiduciary duty of directors expanded to cover the entire range of costs of the mutual fund.

We also believe that Congress either needs to ban soft dollars directly or the SEC needs to be given the authority to do that. You cannot allow funds to shift the costs for certain operating expenses on to shareholders in a form that they cannot see or understand—to take costs that are operating costs that they should have to be paying for directly, and that should be reflected in the expense ratio, and allow them to shift it into the portfolio transaction costs, where they are paid by shareholders and hidden from view. When you have a system that discloses costs in one area and hides them in another, the incentive to move expenses into the hidden arena is too strong. We think a ban on soft dollars is the cleanest approach to solving that problem.

I was here when you held a hearing recently with the officials from the SEC, and one of the issues that they raised is the hard 4 p.m. close to deal with late trading. That has been a controversial proposal because of certain inequities it creates for those of who do not live on the East Coast or who invest through retirement plans. They suggested that the reason they had been forced to take that approach is that they do not have regulatory oversight authority over a number of the intermediaries who handle mutual fund transactions. So, they could not be confident that, if they relied on a system that was based on end-to-end tracking of mutual fund transactions, they would have the authority to ensure that that system was functioning properly.

Chairman SHELBY. They would have to have statutory authority.

Ms. ROPER. Presumably. They seem to think that they need statutory authority to do that. I am not certain whether there is not an alternative without that. But if that is the case, I think that they need at least some limited oversight authority of those intermediaries so we can get to an alternative to the hard 4 p.m. close that does not have its same drawbacks.

These are the issues that we see on a short-term agenda. There is a longer-term issue that I think has been raised in the mutual fund scandals, and that has to do with the abusive sales practices by brokers. The SEC has put forward a number of helpful pro-

posals, fairly bold proposals in some cases, to deal with those problems targeted at mutual funds. But I think the issue of abusive broker-dealer sales practices is a broader, more complex issue that needs a lot more study. The goal should be to narrow or eliminate this gaping divide between the professional advisory image that brokers portray of themselves to the public, the way they market themselves to the public, and the conflict-laden, sales-driven reality of their conduct.

Thank you.

Chairman SHELBY. Thank you.

Professor Pozen, could you elaborate on the conflicts surrounding soft dollars and how a ban would benefit investors, if it would. In other words, how would a ban on soft dollars impact both smaller and full-service broker-dealers and independent research providers?

Mr. POZEN. I think that that is a complex question because we have never had a ban. But I believe there is an issue involving research and then there is an issue involving market data, and then there is an issue involving other services, and I think it is important to distinguish among them.

There are certain products which are now paid for with soft dollars, which are clearly readily available for cash. Those include things like terminals. They include items like computer software, these types of things. In that case, the broker-dealer to whom you are paying the 5 cents a share is only acting as a paying agent. They are acting as a conduit. So, I do not think there would be much disruption if those types of soft-dollar payments were cut out.

But research is a much more complex matter. We have independent research firms, and some of them are excellent and, not surprisingly, we have some independent research firms that are not so good. We have some good research departments on Wall Street or some particular analysts that are good and some that are not so good. We want to encourage securities research. We want to encourage good research.

Any management company like MFS that is really excellent has a large stable of its own analysts, but we need to be able to get research from other places, so I think we need to be very careful about what we do with soft dollars with regard to research, as opposed to other goods and services.

Chairman SHELBY. I think you have answered this, but a number of broker-dealers and independent research providers have advocated that a ban on soft dollars would drive fund advisers to integrated firms that provide in-house execution and research at the expense of independent broker-dealers and third-party researchers.

Mr. POZEN. I think this is an issue and that there are two ways to solve it. One is going back to the old test of readily available for cash, since that eliminates a lot of goods and services other than research, and maybe it should be limited to nonresearch services; and, second of all, as you point out, requiring more of a specific accounting for the elements of the full-service commission because then people would know whether they are paying for research and what type of research they are paying for.

Chairman SHELBY. Professor Bullard, some contend that instead of prohibiting soft-dollar arrangements, the SEC should require broker-dealers and the funds to unbundle commissions and disclose the values assigned to execution and research. In addition, others contend that the SEC should tighten the definition of research, narrowing the scope of products and services that qualify.

How would unbundling commissions and redefining research help to reform soft-dollar practices? In other words, would unbundling create greater transparency for soft dollars and allow competitive market forces to work? If commissions are unbundled, should the underlying cost of the research be disclosed in the expense ratio?

Mr. BULLARD. It is a good question. As Mr. Pozen has already suggested, under the current environment, it is very difficult, even for a huge money manager such as Fidelity and MFS, to negotiate down that 5-cents-a-share commission. Unbundling permits competition between the fund manager and the broker by giving the fund manager a much stronger leverage in order to negotiate a lower price because now the amount of that 5 cents that is paying for research has been separated out.

This proposal was actually made by the SEC a number of years ago when I was at the Commission. It was shot down mainly by the independent researchers on the view that at that time what would get quantified was what they provided and what the Goldman Sachs and the Merrills of the world provided would not because they would argue, that is just overhead. It does not really cost us anything, and they would hurt the independent researchers.

What I am hearing from the independent researchers is they think it can be done. If it can be done, that would be a very good step to promoting competition in that context. It does not do anything, however, to promote price competition between funds and let shareholders see the real impact of different approaches, and that is why putting it in the expense ratio or at least allowing the SEC to provide a number that adds up all of those figures, and let Morningstar and Don Phillips decide whether that is a number that really reflects expenses as your exchange with Mr. Pozen suggested.

Chairman SHELBY. Ms. Roper and Mr. Pozen, could you comment on the effectiveness of unbundling commissions and tightening the definition of research as means to reform soft-dollar practice.

Ms. Roper, we will start with you.

Ms. ROPER. First of all, when we talk about banning soft dollars, we think it is essential that you require the full service firms to unbundle, that you cannot discriminate against independent research and let Wall Street continue to include the cost of its research in the portfolio transaction costs. So, for us, unbundling is part of a ban, as well as a possibility for another approach that stops short of a ban and yet provides significant benefits.

With unbundling, if there is at least disclosure, clear disclosure of what you are paying for when you are paying those commission—it helps to provide transparency. But it still allows those costs that are operating costs to be shifted onto shareholders. If they are legitimate operating costs, they need to be reflected in the operating expense ratio.

Chairman SHELBY. And disclosed?

Ms. ROPER. And disclosed. I think it is Jack Bogel, who said, "It is amazing what you are willing to pay when you are paying with other people's money." You need to exert some market discipline on research costs. We need to make sure that when funds are buying research, they are buying research that adds real value to shareholder and does not simply satisfy certain trading agreements that they have made with brokers.

I think there is progress that can be made short of a ban, in terms of making those costs transparent, making it easier for fund managers to negotiate down their transaction costs. I think the best solution is to make, I mean, you can, if you get portfolio transaction costs into the expense ratio, then you have solved the problem of the cost shifting onto shareholders.

There are different ways to approach this, but the goal of that should be one, that operating costs are reflected in the expense ratio and, two, that costs that should be borne by the fund manager are not shifted onto shareholders.

Chairman SHELBY. Mr. Pozen.

Mr. POZEN. Again, I think that we have to distinguish research from all of the other goods and services. I think that most of the other goods and services are readily available for cash, and management companies should pay cash for them, so then we can eliminate all these issues. The SEC has the authority to do it now. All they have to change is their interpretation of 28(e).

As to research, I think it is much more complicated. We do not want to put independent research at a disadvantage to the full-service firms. And the only way I know to do that is to require an accounting of the items that compose the full-service commission. But then I think you should disclose the average commission per share in the semi-annual reports, and then that would reflect, to the extent there was any bundling, a higher or lower cost so that the shareholders could see. If somebody was reporting an average commission share of 5 cents a share, then they obviously were paying in part for research versus someone who was reporting an average of 3 cents a share. I think from the shareholders' point of view, they should understand what is being paid for commission per share.

Again, what is the real expense of a brokerage transaction? You have to combine the commission with the spread. And if you start to try to compute the spread, I really do not know how you would compute it, and therefore I am very reluctant to say that this is the total brokerage expense for a fund. I think it is more accurate to say this is the average commission per share, recognizing that there are other elements to brokerage cost—the market making spread, a whole series of other things—and that would be a more accurate approach.

Chairman SHELBY. Thank you.

Senator Sarbanes, thanks for your indulgence.

COMMENTS OF SENATOR PAUL S. SARBANES

Senator SARBANES. Thank you, Mr. Chairman.

First of all, I want to thank the members of the panel not only for their statements here today, but also the careful work that has

gone into the written statements which are very helpful to the Committee.

I want to try to get a little more focus. I want to ask each of you what you think are the one or two or, if you feel compelled, the three priorities the Congress should address and whether the SEC has the authority now to do these items. There are different categories. There are some priorities that you could say this should be done, and the SEC cannot do it because they need authorities that they are now lacking statutorily. Therefore, we call on the Congress to give them those authorities. Or, indeed, you can go a step further and say that is not enough, either with respect to those authorities or authorities they already have; they do not seem to be moving to apply a standard that we think is appropriate, and therefore we ask the Congress to apply or impose that standard.

Could we very quickly just get what your top priorities would be in response to that framework of analysis?

Mr. BULLARD. Sure. My top priorities would be all fee disclosure proposals.

First, portfolio transaction costs. And I think it is important to emphasize this is not about the SEC forcing the market to take the commission, plus the spread, which is routinely measured by fund boards at virtually every major complex and forcing that on the market. This is offering the market, this is offering Morningstar a decision about whether it thinks the best number to use for its clients is a number that includes portfolio transaction costs.

I do not see why either MFS or the SEC should make that decision for the market by refusing to let that portfolio transaction cost number be added to the expense ratio that the SEC apparently believes is more truthful, notwithstanding that the most recent study showed it is 43 percent of cost.

In addition to that, dollar disclosure, which Mr. Pozen has just explained, is not too costly, as argued by the Investment Company Institute for the last 9 months, and the consumer groups have consistently supported the best possible, most practical approach that you just described. The SEC, to answer the question of where they are on that issue, has flatly rejected that approach.

Finally, with respect to 12b–1 fees, I think that that is an area where we can have real cost savings if we start making investors see more precisely what they are paying.

I totally agree with Mr. Pozen that I would not repeal 12b–1 unless you still allowed installment loads to be one way that investors paid, but there is nothing inconsistent about the two. The SEC can allow installment loads to be used, as well as front-end loads and back-end loads and any combination thereof, and that is a good thing for investors. It is just that in each case it should come out of the investor's pocket. It should be clearly paid as a result of the investor's relationship with the broker so that you do not have this harmful incentive to buy shares that have an installment load that the fund is paying, so you do not see the cost, as opposed to a front-end load that comes right out of your pocket.

So it would be fee disclosure, fee disclosure, fee disclosure.

Chairman SHELBY. Professor Lutz.

Mr. LUTZ. I would agree that number one, would be to reveal all fees, but to explain them clearly and understandably and in a format that makes them comparable from fund to fund to fund.

Number two, I would design all disclosure documents, forms, et cetera, from a user's point of view. The current proposed forms are designed from a broker's point of view, that is, to ensure that the broker is complying with the regulations. It seems to me that that is backward. We should design all of the documents from the user's point of view.

Number three, I would require all the principals of information design, and any such forms or documents delivered to people before and after the sale. That would include usability testing, document design, plain language, et cetera, so that these are fully understandable as stand-alone documents. You do not need a lawyer and an accountant to explain these things to you.

I think that, for that third one, perhaps the SEC might need some small additional funding for that, but once in place, it would not be a significant expense, but the benefits would be tremendous from the investors' point of view.

Chairman SHELBY. Mr. Pozen.

Mr. POZEN. It will not be surprising to know that the first item I think we should rework is 28(e) for nonresearch items; we need a better accounting and itemization disclosure system for research payments done through soft dollars.

The second item, as we are doing at MFS, I would advocate individualized expense reporting based on these two simplifying assumptions—that the person holds all his or her funds through the whole quarter and that they reinvest their dividends.

The third item, which I think Barbara raised, is an interesting point about the hard close. My concern is that this is not an authority issue so much as a practicality issue. I have been involved with the development of a lot of computer systems, and let us put it this way, it is very rare that you see a big system brought in on time and on budget, and that these macro systems are very expensive and take a long time.

I would actually be in favor of a much simpler system in which any pension fund or any brokerage firm that sends bundled orders to a mutual fund be required to certify that all of the orders were submitted to them before 4 o'clock, and we should have some random audit that should be done by their auditors to make sure that that is really true.

All of the cases of late trading that I know of involve instances of collusion, where people were actively colluding with firms. What we need is both a certification and an outside person, an external auditor and perhaps an occasional SEC random check, to make sure that when these firms put a time stamp on an order and when they certify that it was submitted before 4 o'clock, it actually was.

MFS was never involved with any of these collusive activities, so I am not an expert on them. But it seems logical to me that before developing a hugely expensive computer system, we should again look at what is a good system rather than the best, go to time-stamping, with an external audit and an occasional random check. This might be the most practical way to deal with this very dif-

ficult set of issues for pension funds and brokers that send bunched groups of orders rather than individual orders.

Senator SARBANES. Ms. Roper.

Ms. ROPER. Our top priority, as I said before, is that we develop a system of mutual fund disclosure that is designed with average, unsophisticated investors in mind to give them presale comparative cost disclosure and other key information—about the fund, such as risks or investment style, strategy, who it is appropriate for—at the point that that fund is recommended so that we enable investors—average, unsophisticated investors—to make better mutual fund purchase decisions.

The SEC in our view has the authority to do that, but has not taken that approach. And what is interesting is they have now created the opportunity with their proposed disclosure, at point of sale, which we would like to see as a point of recommendation. But with their proposed disclosure on broker-dealer costs and conflicts, they have introduced a point in the transaction where you can provide that disclosure, but have not taken the next step of saying that we are going to disclose not just these distribution-related issues, but this mutual fund information as well.

Beyond the specific issues, I already outlined where we believe the SEC needs added authority, there is another longer-term issue that I think is extraordinarily important, and that has to do with brokers; sales practices. Anyone who has looked at a broker's ad sees that they portray themselves to the public as if their investment advice were the primary service they had to offer, as if they were objective professional advisers. Yet the law says that they are salespeople and that they are exempt from the Investment Advisers Act to the degree that they give advice that is solely incidental, or merely secondary, to product sales.

I think this disconnect between how brokers market themselves to the public and how they then behave in reality has a lot to do with the lack of effective cost competition in the mutual fund industry. They have an impression that they create with the investor that they are operating in their best interests, but no legal obligation to do so. They have an obligation to make generally suitable recommendations, which, as enforced, falls far short of any obligation to act in their clients' best interests, or to put their clients' interests ahead of their own.

Even where we have for advisers an obligation to put their clients' interests ahead of their own, we have never seen that enforced in a way that makes them take costs and quality of the product into account in their recommendations.

And so I think there is a longer-term agenda of looking at the way that we sell products to the investing public that looks at this disconnect between the image that is planted in the public's mind about what to expect and the reality of practices. That would go a long way toward helping average investors. Because we can do great disclosure. I mean, we could design a system that provided great disclosure. But you have to take into account the reality that the average person who goes in and consults a broker does not expect to second-guess their recommendations. So what are we going to do to make sure that they get the services that they expect when they enter that relationship?

Senator SARBANES. Thank you, Mr. Chairman.

Chairman SHELBY. Professor Lutz, you are a lawyer and an English professor. You have a Ph.D. and a J.D. You state that mutual fund disclosure is confusing because investors are presented with a lot of data that is located in several documents. It seems that fund disclosure documents are written by lawyers for lawyers.

I appreciate that there can often be a balance between insuring sufficient disclosure to protect against legal liability and presenting information in an easy-to-understand manner. For example, some would contend that technical language is necessary in order to protect the funds against subsequent allegations that they did not provide full disclosure. How do you balance these interests and give investors the information that they need to make informed investment decisions, as well as comply with the necessary language to protect the——

Mr. LUTZ. There is no conflict.

Chairman SHELBY. No conflict. I am glad to hear that.

Mr. LUTZ. Well, stop and think for a second. We are talking about using plain language to explain things. How can we be distorting or hiding?

Chairman SHELBY. The people that contend otherwise, it is not a good argument, in other words.

Mr. LUTZ. But I have done it. The State of New Jersey has a plain language law which it passed over 20 years ago. I was in law school at the time that the New Jersey legislature passed it. I remember the instructor in one of my courses saying, he called it the Employers' Full Employment Act because we would be litigating all of these plain language documents. Since that time there has not been one lawsuit in the State of New Jersey over the plain language documents that are used.

The Michigan State Bar Association a few years ago conducted a search as far as they could find any lawsuits, whether Federal or State level, brought because of plain language, and they found none. Since I have translated technical language into plain language, stop and think for a second. What you are saying is that only these words can communicate this reality. It is linguistically impossible. This is why we have synonyms.

Chairman SHELBY. Ms. Roper, you know the SEC has recently proposed rules requiring brokers to make certain disclosures to investors at the point of sale. Would you discuss how investors might benefit from point of sale disclosure regarding the cost, the expenses, and performance of the fund that they are purchasing.

Ms. ROPER. Right. First of all, I want to move the timing back. I want it at point of recommendation, not at point of sale. I think if you get a document when you are ready to write the check or transfer the money, you have made your decision. You are not going to then carefully review that information. So the information needs to come at the time when you are still considering your purchase so that you can factor it into your purchase.

It seems to me to be simple common sense, that if we want people to make cost-conscious purchase decisions, that we should give them information about costs before they make their purchase.

Right now, if you buy through a broker, you do not have to get that prospectus until 3 days after the sale. The likelihood that you

will then take that information and act on it and try to rescind that transaction or bear the costs of changing into a lower-cost fund is just remote, at best. If you want people to have information they are going to act on, common sense dictates it has to be presale.

I think if you then present the information in a way that is compelling—not just data, as Professor Lutz said, but information in a way that is compelling. You could, for example, say, when we talk about comparative information—and I do not have all of the answers about the best way to do this—but say you said this is how the costs of your fund compare to the category average costs, this is how it compares to an index fund that invests in the same type of securities, and this is the dollar cost implications of that difference over 1-, 5-, and 10-year periods. Assuming the same rate of return, this is what you are going to pay more or this is what you are going to save, by virtue of the costs of your fund, how it compares. If you give that information to people in advance of the sale and say, look, you are going to pay $900 extra over the next 10 years because you chose this fund rather than one that has just average costs or you are going to pay more than that extra because you chose this actively managed fund rather than a comparable index, you might get people to factor costs into their decisions.

What that means is that 30 years down the line when they are retired, it is tens of thousands of dollars that they have in their retirement savings account that they would not have had, had they invested in a high-cost fund. That, to me, is why we have to care about this issue. We know that people are not making adequate preparations for retirement. We have a way that we can help address that situation by giving them information that they can use. I think we should be doing it. We should reflect, in our approach to disclosure, the fact that the markets have changed.

Chairman SHELBY. Information they can use before they make their decisions.

Ms. ROPER. Before they make their decision, and information that is designed with the idea in mind that the nature of investors has changed in the last 20 years, that we have a lot of people in the markets today who are not financially sophisticated. We need to design a system with them in mind.

Chairman SHELBY. Professor Bullard, do you have any comments?

Mr. BULLARD. Sure. I would like just to add to your question about liability versus plain English. I think there are situations when they can be in conflict. To give you an example, there was a District Court decision recently in which a plaintiff alleged that there was a fund that had A, B, and C shares and that there was no rational investor for whom B shares could possibly be the best investment. The question was do you have to tell them that in your prospectus? Do you have to say in your prospectus, look, we are offering you A, B and C, none of you could conceivably be better off with B?

The Court said, okay, I will assume that that is the case, and I will find there is absolutely no obligation to disclose that no one would be better off buying B shares. This was the holding of the Court.

The SEC has specifically decided not to require that you explain to people the pros and cons of different classes and that you do not have to tell people when one of those classes would never be the best investment.

Now imagine that you are counsel for that fund, and they come to you and they say, well, clear language would require that we tell them do not buy B shares, even though we are offering them, and the lawyer has to tell them you would be out of your mind to say anything about those B shares because, first of all, you will not sell any and second, you will get sued, and the District Court has just told you, you are completely insulated if you keep your mouth shut.

There are other instances like that when they are in conflict. That is why we need the type of disclosure that we have been talking about today.

Chairman SHELBY. Mr. Pozen, do you have any comments?

Mr. POZEN. We had an effort maybe 5 or 6 years ago, and I actually designed what was called a short-form prospectus, and at that point people were trying to come to grips with the fact that most investors will not read a long prospectus. And with all respect to Professor Lutz, if it is a 20-page prospectus, even with his great English, I am not sure they are going to read it.

Chairman SHELBY. But they have a better chance to read it.

Mr. POZEN. They would have a better chance, but——

Chairman SHELBY. And a better chance to comprehend.

Mr. POZEN. I agree, but they would have a much better chance if we could have a 3- or 4-page prospectus in Q&A form, and that is what was developed, plus a backup longer form.

I guess I am just wondering out loud whether or not, regardless of how well you write the prospectus, if it is 20 or 25 pages long. I have a feeling that a lot of people I know who are not investment experts would still go to sleep on the prospectus. I urge the Committee to look at these short-form prospectuses that were done. They were done especially for 401(k) plans. They were all done in similar question and answer order. They gave you the gist of the prospectus so you could get most of what you want quickly.

The real dilemma here is the investor will read something that is short and gets at the major points, but there are a lot of other points that the investor probably should take into account. Once you start putting all of those in, even though you do a good job, like Professor Lutz says, it gets to be a 20- or 25-page document. So, I am still trying to figure out how you resolve that tension.

But I know one thing, when we did a number of focus groups, more people will read a 3-page prospectus than will read a 20-page prospectus, no matter how well that 20-page prospectus is written.

Chairman SHELBY. But the bottom line is what is in that information and how well-disclosed it is.

Mr. POZEN. I agree with that. But still, if you are going to do a 3-page prospectus with a backup, you inevitably have to focus those 3 pages on the main points, and there are other points which can be important in individual circumstances which you are not going to be able to get into those 3 pages.

Chairman SHELBY. But what we are trying to do, at least this would be my perspective, is to have a well-informed mutual fund purchaser.

Mr. POZEN. Sure.

Chairman SHELBY. You know, a purchaser of mutual funds would know what the costs were. Nothing hidden, no hidden agenda——

Mr. POZEN. I agree with that.

Chairman SHELBY. —nothing hidden by words or deeds and so forth. In other words, we have all been taught, I think, that an informed purchaser is the best purchaser because then they can trade or not trade in the marketplace.

Mr. POZEN. My experience has been that if we really want to accomplish that goal in practice, we need what I call "tiered" disclosure. We need a short-form prospectus in 3 or 4 pages that you can look at quickly, and then we need that to be backed up with a 20- or 25-page prospectus that Professor Lutz would write in plain English.

Chairman SHELBY. All of this reflecting the truth, though.

Mr. POZEN. Of course. All I am trying to say is that there is a tradeoff—the more information you give people, the longer the prospectus is, the less likely people are going to read it. What I mean by a tiered disclosure system, what I would like to see, is a good Q&A, short-form prospectus which would be attached to the long-form prospectus, so that people would have the benefit of getting the main points in those 3 or 4 pages. Then if they wanted more, we would encourage them to read the full prospectus.

As a practical matter, from my experience with focus groups, many investors are not prepared to read the full 20 to 25 pages no matter how good the English is, no matter how good the disclosure is. So that is why I am in favor of two documents—a short-form prospectus and then a full prospectus written in plain English, as Professor Lutz suggests.

Chairman SHELBY. Professor Lutz, throughout this reform process, we have tried to remain mindful as to the increased costs that might accompany the proposed regulatory reforms because ultimately the shareholder is going to pay the cost. Could you estimate how much it would cost mutual funds and broker-dealers to revise their disclosure practices to incorporate the information design and usability reforms that you have suggested. If you want to do that for the record or you can do it now.

Mr. LUTZ. I could not give you a dollar amount. Based on my experience, I can tell you that it is capital intensive, but it is something that, once done, lives for the life of the investment.

Chairman SHELBY. What is done is there, is it not?

Mr. LUTZ. So the costs are spread out over the life of the form. But the forms that we are looking at would come from the SEC and would be model forms.

They could be easily customizable through desktop publishing, so it really does not become that much of an expense once it is installed, as a continuing expense.

Let me say one thing about the short form, if I may.

Chairman SHELBY. Okay.

Mr. LUTZ. I helped design short forms at the SEC. When we did the plain language project, we did a number of them. I think there is a misperception here about a 20-page document and people not wanting to read it. It is not a matter of plain language. It is a mat-

ter of document design, making the information attractive, enticing, making you want to read it.

Chairman SHELBY. Understandable.

Mr. LUTZ. Drawing you into it. What do we do with magazines? The magazines make you want to read them. That is the whole purpose of their design. We should do the same thing. There is no reason why we cannot.

Chairman SHELBY. You could usher in a new era in the average American's financial literacy, could you not?

Mr. LUTZ. Absolutely, and there is something else that nobody has mentioned here. We are all talking about writing these documents of what we want them to know. One of the things that I have learned as a teacher is that I never know what they do not know, and I am always amazed to find out what they do not know.

Chairman SHELBY. Should it not be what they should know?

Mr. LUTZ. Well, you start with what they want to know first. Let me give you one simple example. I have done work with some of the health disclosure issues currently in the medical profession, and the hospital had designed a very good document on a procedure to get the permission of the patients, but none of the patients were paying any attention to it. And when they sat down and talked to them about it, the first question that the patients had was, how much does this cost? Because if I cannot afford it, I am not going to read this pamphlet. And the hospital never thought to even mention cost in the document. It was not in their minds.

We do not know what is in the minds of investors. That is why we do usability testing, to sit down and find out what it is they want to know, and that becomes our starting point for disclosure, and I agree, you are absolutely correct. We have to also educate them at the same time, but if we are going to get them to read those 20 pages, we are going to lure them in by giving them what they want to know.

Chairman SHELBY. After all, it is their money, is it not?

Mr. LUTZ. All of it is their money.

Chairman SHELBY. It is their investors' money, the $7 trillion, the 100 million people, more or less, that invest, and they should have the knowledge of what is happening to their money.

Mr. LUTZ. They should have some say in it someplace along the line. Every penny of every expense and every salary is their money.

Chairman SHELBY. Mr. Pozen, in addition to the governance reforms proposed by the SEC, some people contend that additional reforms are necessary.

First, some contend that Congress should amend the Investment Company Act to give fund boards authority to hire and fire the investment adviser without having to get a shareholder vote. Many believe that this authority would shift the balance of power from the adviser to the board.

Second, others contend that Congress should redefine the fiduciary standards for fund boards and advisers.

What is your perspective on these two proposals, the issues?

Mr. POZEN. On the first one, in terms of the management contract, I think that there is a lot of power now in the independent directors to terminate management contracts and to change management contracts. Also to the extent that the shareholders have

bought into a fund because they have been attracted by the management company, I think they have a right to have some say in whether or not the management company that they chose, would continue to be there.

Chairman SHELBY. But does the board not run companies?

Mr. POZEN. The independent directors of the management company——

Chairman SHELBY. The shareholders elect members of the board. That is true of anything. So if the board runs things, should they not have the ability to hire and fire?

Mr. POZEN. They have the ability to fire a management company now.

Chairman SHELBY. The board now has the ability, in corporate America, to fire a chairman or to fire a president.

Mr. POZEN. So I have heard.

[Laughter.]

Chairman SHELBY. Is this not right, though?

Mr. POZEN. I believe that the independent directors of a mutual fund board now have the power to terminate the advisory contract of a director, and they have the power also to change the terms, to negotiate new terms of the contract.

Chairman SHELBY. But without getting a shareholder vote.

Mr. POZEN. Yes, without getting a shareholder vote. I think they have the power now. They have the ability to terminate an advisory contract now.

May I ask Professor Bullard for a little help on this one? Do the independent directors have this legal authority?

Mr. BULLARD. The directors at any time can terminate the adviser, as long as they are willing to be sued for the next 5 years by the fund manager. If you are going to do something, you might provide them that protection, something that certainly would be appreciated by the Navellier directors, who I think 7 years after the battle they had with the fund manager are still in litigation.

Mr. POZEN. I have terminated subadvisers without a lawsuit.

Chairman SHELBY. But you cannot be intimidated by the adviser. What if he is a sorry adviser, and you say, "Gosh, what you are giving me is wrecking the fund. You have to——"

Mr. POZEN. There are two different issues—a legal issue and a factual issue. Legally, I believe that the independent directors now have the authority to terminate the adviser if they do not think the adviser is doing a good job and that that power is there and is already in the statute in Section 15 of the Investment Company Act.

As to the second question of fiduciary duties, I think that there already are fiduciary duties under State law, the duty of care and duty of loyalty that are incorporated through Section 36(a) of the Investment Company Act. And Section 36(b), which is on fees, has been heavily litigated, and I think the case law is pretty good.

The last thing I would like to do is to change the fiduciary standard so that we then have another 10 years of litigation to try to figure out what exactly that standard means.

So, I believe that on these two issues, the statute and the case law are already in a reasonable position.

Mr. BULLARD. Mr. Chairman, if I could add something to that. The record under the fiduciary standard in the case law is pretty

good because no fund manager has ever lost a decided case under Section 36(b) in a private action.

Mr. POZEN. But there have been a lot of settled cases.

Mr. BULLARD. There have been a lot of settled cases.

Mr. POZEN. That is true of most class action lawsuits. Very few of them go to actual judgment.

Mr. BULLARD. Right, that is true. And frankly, I am not that big a fan of private class actions as a way of inducing competition, but even more noteworthy is the fact that in 34 years, this provision the SEC specifically asked for has never exercised its authority under 36(b) to bring a true excessive fees case against a board that signed off on an excessive management fee.

There have been two 36(b) cases, and neither is really an excessive fee case. They are essentially churning cases where fees being charged that should not have been charged in the first place, not that the advisory agreement fee was too high.

Mr. POZEN. I think you would agree, Professor Bullard, it is not for lack of legal authority that the SEC has not brought a case.

Mr. BULLARD. That is correct. The SEC has made a conscious decision not to bring those cases, and it is a real gap in their enforcement program, and there are cases out there they can bring.

Chairman SHELBY. Why, though? What is behind the conscious decision?

Mr. BULLARD. The investment management directors have said that they tried to find cases and have not been able to find them. I think that they need to be more aggressive. I think that this is not the Fidelitys that they should be suing, as are typically the defendants in the civil cases. These are the outliers, where the expense ratio is 5 or 10 percent of assets, and the performance has, for 5 or 10 straight years, lagged the S&P 500, where there is no rational basis for the fund directors to approve those contracts.

I think Mr. Pozen would agree, if you can give me those set of facts, that is a case where the SEC should sue that fund board under 36(b).

Chairman SHELBY. Mr. Bullard, you state that 12b–1 fees have evolved beyond their intended purpose and are now used as substitutes for sales loads. In a sense, fund advertising cost and distribution costs are blended.

Comment, if you would, on the SEC's concept release regarding changes to Rule 12b–1 and how advertising and distribution fees might be separated, also how would such a separation impact mutual funds and broker-dealers.

Mr. BULLARD. Well, the first step the SEC has taken and has said that you simply cannot use a fund asset in the form of the fund's brokerage to pay brokers for sales. I think the SEC will finalize that position and that issue will be taken care of.

As to the separation of the two, I do not believe the SEC can really do what is necessary because of the current lack of statutory authority to expressly allow, if 12b–1 fees are not used, some other source of fund assets to pay for, let us say, *Money* magazine advertisements, what I would call classic distribution services. You need Congressional action, you need an amendment to Section 12b to expressly allow the management fee to be used for that purpose, and

thereby give the fund manager incentive to keep those costs low, albeit allowed to spend that money.

As far as the sales charges go, I agree, as I said before, I agree with Mr. Pozen. You should not repeal 12b–1, if you are then going to be depriving shareholders of the ability to, instead of paying a front-end load or a back-end load, spread that load out over time. But that is already possible under SEC rulemaking authority. They can allow, under whatever set of standardized arrangements they choose, brokers to collect a front-end load on an installment basis, be it 25 basis points a quarter, 100 basis points at the end of each year, either paid by through a check written by the investor or paid by automatic redemptions from fund shares.

So there are a lot of different ways to do it. The key is not to change any of the payments that are currently made, and not in any way to force any reduction or increase. It is simply to rationalize the way in which they are paid. When you pay your broker, it is coming out of your pocket, whether it is an installment load or not, and you can see what that cost or that relationship is and understand that this is not a fund cost. This is a cost that you are incurring because you need the services of that broker, and that is what will make you think twice about whether you are paying too much and whether you need to get smarter about making more investment decisions perhaps with a little less help.

Chairman SHELBY. Do you agree with Professor Bullard?

Ms. ROPER. I do. When you look at the evolution of 12b–1 fees, I think you need to keep in mind that there is a reason we have gone to compensating brokers this way. And it is because when we first created no-load funds and investors were presented with a clear choice between paying a load and not paying a load, they said, “Well, I do not want to pay a load. Why would I want to pay this sales charge?” And so there was an effort made to shift the way that we pay brokers so that it is less evident to investors.

Chairman SHELBY. But should the investors not know?

Ms. ROPER. Yes. As you look at how you reform 12b–1 fees, the goal should be that investors understand what they are paying for the services from their brokers and what they are paying for the operations of the funds and how those two things are separate.

Right now the disclosures I do not think effectively do that. I do not think there is a single one approach that solves the 12b–1 problem, but I agree you should have an ability to pay an installment load. You should recognize that that is what you are paying for the services of the broker and, frankly, I think it should be something that is negotiated between the investor and the broker and not set by the mutual fund.

When I buy a share of stock, the company that issues that stock does not tell me how much I have to pay my broker to buy that stock, but the mutual fund does. And so what you do is you take that element of broker compensation out of the competitive marketplace. It is not negotiated between the investor and the broker in the same way, and you create a system in which mutual funds compete to be sold instead of competing to be bought, and they compete to be sold by offering financial incentives to the broker.

And so you have a system of reverse competition that drives costs to investors up, not down, and makes it possible for mediocre

funds to continue to survive by virtue of offering generous compensation to the broker. I think the SEC concept on 12b–1 fees is a very helpful start, but there is a broader look that needs to be taken on how we design this system so that it better aligns investor interests with the funds. It better protects investor interests, better ensures that there is an incentive on the part of the broker to sell them a good fund instead of one that pays the broker well.

Chairman SHELBY. Mr. Pozen, how, if at all, should 12b–1 practices be reformed, from your perspective?

Mr. POZEN. I, again, think that the key is for investors to know what they are getting. I think it is perfectly reasonable for some people to want to pay up front, for other people to want to pay on an installment basis. The question is: Do they know exactly what they are paying on an installment basis?

You do have in the prospectuses now a separate line for 12b–1 fees, but it is expressed in basis points. Maybe we should express this in dollars so people would have a better sense of what it actually is. As long as they know, at the point of sale, what the various fees are, including the 12b–1 fees, then we should give them whatever choice they want.

Mr. BULLARD. Chairman Shelby, if I could just clarify one point Ms. Roper made.

Chairman SHELBY. Go ahead.

Mr. BULLARD. When she said that an ultimate goal would be to try to "unfix" these payments, just so we understand, that under the Investment Company Act, prices for mutual funds are fixed, not just with respect to the shares themselves, but what you pay to the broker. And ultimately it would truly be a courageous step for the Committee to look at the question of whether we need to repeal fixed pricing, which the Division has supported repealing for almost 15 years, the Division of Investment Management.

Mr. POZEN. I am sorry. I do not understand what you mean by "fixed pricing."

Mr. BULLARD. Well, under the Investment Company Act, Section 22(d), a broker is only allowed to sell shares at the price in the prospectus, and that price in the prospectus includes not only the NAV or the way the NAV is calculated, but also the percentage that the broker gets paid.

A broker cannot give you a discount on the front-end load, for example, it cannot give you a rebate of the 12b–1 fee, for example, if you happen to be an investor who requires a lot less services than some other investor, and that is because, under 22(d), those prices are required to be fixed.

In a SEC Division of Investment Management study in 1992, the Division came out in opposition to 22(d) and in favor of its repeal, and I think that that ultimately should be the direction that we are going to be going in, whether it is now or later. Just as commissions were unfixed in the 1970's for a retail brokerage, it is inevitable that they will become unfixed in the fund industry. It is just going to be very hard to do that as long as we force the tying of the product price and the distribution price. You have to separate the distribution costs from the product costs in order then to allow the freeing up of the distribution costs and competition between brokers, as far as their charges go.

Mr. POZEN. Chairman Shelby, with all due respect, I believe Professor Bullard is technically right, but as a practical matter, the results are quite different.

You are allowed, under Section 22(d), to create any waiver you want, and the SEC is extremely flexible in allowing you to create many types of pricing waivers. Therefore, you will see differential sales loads based on how much you invest, based on whether you are a trust, based on whether you are a retirement plan. There is a broad range of flexibility in pricing.

However, if you decide that you are going to treat, say, all charitable trusts one way, and you put it in your prospectus, then you have to follow the language. But you can even say for a charitable trust, if the charitable trust invests more than $25,000, we will charge them 2 percent load, rather than 4 percent load.

So, in practice, Section 22(d) is a weak constraint; I am impressed by how much flexibility that Section provides load waivers. And I think, in the scheme of things, increasing that flexibility is a minor point, rather than a major point.

Mr. BULLARD. Just to clarify, all of those variations are done by the fund, not by the brokers. Once Fidelity or MFS sets all of those variations, the brokers have no leeway to change them based on their actual relationships with their clients, based on the services their clients provide to them and how much those clients value those services.

Mr. POZEN. I can assure you, if the brokerage community says we need a certain set of waivers, then those waivers will definitely be provided.

Mr. BULLARD. Yes, but brokers like fixed commissions. Consistently, if you have regulators come in and fix prices, it is more profitable for the industry.

Chairman SHELBY. Let us give Ms. Roper the last word.

Ms. ROPER. I would just say the last thing the brokers want is for customers to be able to negotiate those costs and to have them subject to actual price competition. It is not in their interests.

Chairman SHELBY. What we really want is the market to work, do we not?

Ms. ROPER. Right. What I think Professor Bullard and I are saying is this is an area where the market does not work. It is not allowed to work. It is not allowed to discipline those costs.

Chairman SHELBY. I want to thank all of you for appearing today. We are continuing to learn a lot as we look into these abuses in the mutual fund industry. I want to thank all of you.

Mr. BULLARD. Thank you, Chairman.

Ms. ROPER. Thank you.

Chairman SHELBY. The hearing is adjourned.

[Whereupon, at 12:02 p.m., the hearing was adjourned.]

[Prepared statements and additional material supplied for the record follow:]

PREPARED STATEMENT OF MERCER E. BULLARD

PRESIDENT AND FOUNDER, FUND DEMOCRACY, INC.
ASSISTANT PROFESSOR OF LAW, UNIVERSITY OF MISSISSIPPI SCHOOL OF LAW

MARCH 23, 2004

Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee, thank you for the opportunity to appear before you to discuss enforcement and regulatory developments in the mutual fund industry. It is an honor and a privilege to be before the Committee today.[1]

Introduction

The Committee's topic today is current investigations and regulatory actions regarding mutual funds, and this is precisely where the Committee's focus should be. With more than $7 trillion in assets, mutual funds are this country's most important investment vehicle. The ongoing scandal in the mutual fund industry has demonstrated the need for significant reform in mutual fund regulation. I applaud this Committee's deliberate, thorough, and careful review of the full range of issues facing fund regulators and the fund industry today.

I commend the efforts of the Commission, Attorney General of the State of New York, Secretary of the Commonwealth of Massachusetts, National Association of Securities Dealers (NASD), other regulators, and the Justice Department for their forceful and diligent investigation and prosecution of persons and firms who have violated the law and investors' trust.

I applaud the efforts of the Commission and NASD to identify gaps in regulation and propose practical, effective solutions. As a former member of the staff of the Division of Investment Management, I am especially impressed with the Division's extraordinary accomplishments of the last 4 months. During this time, the Division has made more progress in reforming mutual fund regulation than in any period in its history.

As the Commission has itself noted, however, there are many important gaps in regulation that it does not have the authority to address. There are also instances in which the Commission has the authority to effectuate important reforms, but it has chosen not to do so.

Where the Commission cannot or will not implement reform, legislation provides the only hope for promoting competition and adequately protecting investors. Part I of this testimony discusses the following areas where Congressional action is necessary: mutual fund governance, disclosure of fund fees, soft-dollar and distribution arrangements, and misleading fund names.

Part II briefly describes other areas where reform is needed and the Commission has taken reasonable steps in the right direction. This Committee should note, however, that the Commission is divided on a number of these matters. The Committee should continue to be vigilant that a minority of the Commission does not succeed in derailing these efforts.

I. Areas Where Legislation is Necessary

MUTUAL FUND GOVERNANCE

The problems with mutual fund boards fall into two categories: (1) oversight and accountability, and (2) independence and authority. Fund directors will not actively negotiate fees to keep fund costs low or assiduously fund managers' conflicts of interest without guidance as to the minimum standards to which they will be held and accountability for living up those standards. No amount of board oversight and accountability will help shareholders if directors do not have the independence and authority to effectively carry out their mandate.

Mutual Fund Oversight Board

As I discussed in prior testimony,[2] the mutual fund scandal reflects pervasive, systemic compliance failures that require structural changes in the way that fund boards are regulated. These failures can be partly traced to a lack of guidance regarding the minimum standards to which boards will be held in the fulfillment of their duties. *To address this problem, Congress should create a Mutual Fund Oversight Board that would provide such guidance.*

This Board would promulgate informal, minimum standards for fund boards regarding a range of issues, including fee negotiations, fair value pricing, market timing policies, redemption policies, and distribution practices. The Board's focused mandate would give it the flexibility to respond quickly to changing circumstances and to develop an unparalleled depth of expertise regarding the role of fund directors. The model for the Board, the Public Company Accounting Oversight Board, is

widely considered one of the most effective creations of the Sarbanes-Oxley Act of 2002.[3]

The Commission does not have the authority to create a Mutual Fund Oversight Board or the capacity to provide effective guidance itself. For example, the Commission issued guidelines for the approval of 12b–1 plans in 1980 that have never been updated,[4] despite repeated promises do so.[5] The requirements of the formal rule-making process, among other things, make it difficult for the Commission to maintain current guidelines for fund directors. The breadth of the Commission's mandate also makes it difficult to stay continually focused on the evolving responsibilities of fund boards. The Oversight Board would effectively supplement the Commission by providing the kind of current, continuous guidance necessary for boards to function effectively.[6]

The Board also would have examination and enforcement authority over mutual fund boards. It would be charged with identifying potential problems in the fund industry and ensuring that fund boards are actively addressing these problems before they spread. For example, the Board would promulgate guidance regarding current regulatory issues and best practices regarding how to deal with them, and examine boards to ensure that they are taking necessary steps to protect shareholders.

One reason that an oversight board is needed is that the Commission has not held fund boards accountable for misconduct. The Commission's enforcement actions in the wake of the mutual fund scandal have suffered from a major flaw. To date, not one case has been brought against an independent fund director, despite settlements involving dozens of different complexes and individuals.[7] A settlement was recently announced regarding fund directors who exempted a market timer from a fund's redemption fee, yet the only punishment for such misconduct was that the directors would have to retire by the end of 2005.[8]

In 2003, the Commission agreed to settle charges with the directors of the Heartland funds with the sole penalty being a cease and desist order.[9] These directors were responsible for overseeing the worst mispricing incident in the history of the fund industry, in which shareholders in two Heartland funds lost 70 percent and 44 percent of the savings in a single day in 2000. Nonetheless, they were permitted to retain their directors' fees—even those earned during the 3 years that the case was pending. In dissent, Commissioner Campos stated:

> The investigation in this case presents significant evidence, if proven at trial, of directors, having unambiguous information that funds' NAV is significantly overstated and that the funds were illiquid, failing to act in any meaningful way to protect shareholder interests.[10]

In view of the extraordinary level of misconduct involved in the Heartland matter, and the impotence of the penalty imposed, it is difficult to imagine the Commission justifying any sanction on any fund director in connection with current mutual fund scandal.

For 34 years, the Commission has abdicated its statutory duty to prosecute funds and directors for excessive fees. Section 36(b) of the Investment Company Act, which was passed in 1970, provides that a fund director and fund manager shall have a fiduciary duty with respect to the fees charged by the fund, and tasks the Commission with bringing actions against directors and fund managers who violate this duty. The Commission has never brought a case for excessive fees.[11]

The Mutual Fund Oversight Board would remedy the Commission's failure to hold independent directors accountable by promulgating and enforcing minimum standards of conduct for fund boards.

The Board would be financed from assessments on mutual fund assets to provide an adequate and reliable source of funding. Board members would be persons with specific expertise in the fund industry and would be appointed for 5-year terms by the Commission to ensure their independence. This model, which ideally combines the strengths of independent, expert oversight with the advantages of a reliable and adequate funding source, would do more to restore confidence in the fund industry and protect fund shareholders than any changes in the makeup, qualifications, or authority of fund boards.

Board's Fiduciary Duty

Creating a Mutual Fund Oversight Board alone will not be sufficient to ensure that fund directors are held accountable for failing to protect the interests of shareholders. Under current Federal law, the only express fiduciary duty that applies to directors is limited to fees paid to the fund manager.[12] When a fund's high fees are attributable not to fees paid to the fund manager, but to fees paid on account of the administrative expense of operating a small fund, this fiduciary duty is not trig-

gered. Thus, a fund director's decision to offer a fund with an 8 percent or 10 percent expense may be reviewable only under a toothless State law standard.[13] Congress should enact legislation that creates a fiduciary duty for fund directors that would require, for example, that directors affirmatively find that the fund could be a reasonable investment in light of its investment objective, performance history, and expenses. *The Commission does not have the authority to establish such a fiduciary duty.*

Directors' Independence and Authority

As discussed above, recent frauds demonstrate systemic weaknesses in mutual fund compliance. These systemic weaknesses necessitate the creation of a regulatory structure, such as a Mutual Fund Oversight Board, that is designed to ensure that fund boards of directors fulfill their responsibility to protect shareholders. A fund board cannot protect shareholders unless its independent members have the independence and authority necessary to counter the influence of the fund manager.

In order for independent directors to provide oversight that is truly free of the fund manager's control, the board's chairman must be independent, the board must be at least 75 percent independent, and the definition of independent director must be amended to exclude former directors, officers, and employees of the fund manager. In addition, independent directors should have to stand for election at least every 5 years. Independent fund directors often are appointed by the fund manager or nominated as the result of a relationship with the fund manager and never stand for election because funds—unlike publicly traded companies—are not required to elect directors periodically. Finally, as suggested by the Commission, Congress should require that independent fund directors perform a self-evaluation at least annually and meet at least quarterly in a separate session, and expressly authorize independent directors to hire their own staff.

The necessity of these reforms has been well-documented over the last year—in a wide range of contexts including statements by Members of Congress, Commission releases, and Congressional testimony—that does not need repeating here.[14] *What needs to be emphasized here is that, contrary to popular perception, the Commission does not have the authority to enact these reforms.* The Commission does not have the authority to require a fund to have an independent chairman or a 75 percent independent board, to hold separate meetings of independent directors, or to require annual self-evaluations. These reforms can only be accomplished through legislation.

Although the Commission has proposed certain fund governance rules,[15] these will not be remotely as effective as legislation for two reasons. *First, the Commission has excluded critical reforms from its proposal.* The Commission's proposal includes no provisions that would prevent a former director, officer, or employee of the adviser from being considered to be an independent director. Nor does the Commission's proposal include any provision regarding the election of independent directors, thereby effectively leaving their election in the hands of fund management. *Only if Congress passes legislation will independent directors have to be truly independent and at least periodically meet with the approval of fund shareholders.*

Second, the Commission's proposal does not effectively require fund boards to be 75 percent independent and have an independent chairman. In fact, as the Commission concedes, the proposed rules "would apply only to funds that rely on one or more of the Exemptive Rules."[16] The Exemptive Rules to which the Commission refers are rules that many funds may, but are not required to, rely on in the operation of their funds. For example, a fund can charge a 12b–1 fee only in compliance with Rule 12b–1. The Commission proposes to amend Rule 12b–1, among other Exemptive Rules, to require that funds relying on Rule 12b–1 comply with certain fund governance provisions.[17] If a fund cancels its 12b–1 plan, however, it will be able to replace its independent chairman with an officer of the fund manager and reduce the percentage of independent directors from 75 percent to 40 percent (the statutory minimum), thereby returning control of the board and fund in the hands of the fund manager.

The Commission claims that, "[b]ecause almost all funds either rely or anticipate someday relying on at least one of the Exemptive Rules, we expect [the governance conditions] would apply to most funds."[18] This is no doubt true, but it is not "most funds" at which these provisions are targeted. These governance measures are targeted at funds where the likelihood of fund manager overreaching is greatest. The Commission's proposal has a fatal Achilles' heel. When the independence of the board is most critical, that is, when there is a conflict between the board and the fund manager, the board will know that the manager need only cease relying on the Exemptive Rules to dismiss the independent chairman and eviscerate the independent majority. The question is not whether, at any given time, "most funds" have truly independent boards, but whether fund directors have the requisite independ-

ence and authority when they most need it—when they are challenged by the fund manager.

This is precisely the scenario that unfolded when the independent directors of the Yacktman Funds confronted Don Yacktman, the fund manager. At the time, the Funds charged a 12b–1 fee under Rule 12b–1, which required that the board be "selected and nominated" by the independent directors. Mr. Yacktman engineered a proxy battle that led to the ouster of the independent directors and the installation of an "independent" slate of directors that he selected and nominated. No longer able to rely on Rule 12b–1, Mr. Yacktman cancelled the fund's 12b–1 plan. The "selected and nominated" provision that was intended to ensure the independence of the board was swept aside at the very moment when it was most needed. The lesson from the Yacktman experience is that the Commission's proposal will only guarantee an independent chairman and a 75 percent board as long as the fund manager does not object. The independent chairman and independent director majority will know that they serve at the whim of the fund manager. Only legislation can guarantee that a board must be 75 percent independent and that its chairman is not under the control of the fund manager.

FEE DISCLOSURE

As the Commission has recognized, fund fees "can have a dramatic effect on an investor's return. A 1 percent annual fee, for example, will reduce an ending account balance by 18 percent on an investment held for 20 years." [19] Notwithstanding the importance of fees, "the degree to which investors understand mutual fund fees and expenses remains a significant source of concern." [20]

In many respects, investors' lack of understanding is directly attributable to the way in which fees are disclosed. The current expense ratio is misleading because it excludes what can be a fund's single largest expense: Portfolio transaction costs. The 12b–1 fees are misleading because they create the impression that funds that do not charge 12b–1 fees therefore do not incur distribution expenses. Fund fees are disclosed in dollars based on hypothetical amounts, rather than a shareholder's actual costs, and the location of this disclosure makes it unlikely that investors will pay attention to this information. Nowhere are funds required to put their fees in context by comparing them to fees charged by index funds and comparable managed funds. *The Commission has failed to support or actively opposed reforms designed to address each of these problems.*

Portfolio Transaction Costs

The current expense ratio, which to be accurate should be referred to as the "partial expense ratio," excludes portfolio transaction costs. Portfolio transaction costs are the costs incurred by a fund when it trades its portfolio securities. Some portfolio transaction costs are easy to measure. For example, commissions paid by funds are disclosed as a dollar amount in the Statement of Additional Information, which is provided to shareholders only upon request. Other portfolio transaction costs must be measured indirectly, such as spread costs, but their existence and their substantial impact on fund expenses is no less certain.

The Commission concedes that portfolio transaction costs constitute a significant expense for fund shareholders. "[F]or many funds, the amount of transaction costs incurred during a typical year is substantial. One study estimates that commissions and spreads alone cost the average equity fund as much as 75 basis points." [21] A recent study commissioned by the Zero Alpha Group, a nationwide network of fee-only investment advisory firms, found that commissions and spread costs for large equity funds, the expenses and turnover of which are well below average, exceeded 43 percent of the funds' expense ratios.[22] A recent survey by Lipper identified at least 86 equity funds for which the total amount paid in commissions alone exceeded the fund's total expense ratio, in some cases by more than 500 percent.[23]

Notwithstanding the significance of portfolio transaction costs, the Commission has opposed including these costs in the mutual fund expense ratio. In a June 9, 2003, memorandum, the Commission demonstrated that it had already prejudged the issue of the disclosure of portfolio transaction costs.[24] It concluded that "it would be inappropriate to account for commissions as a fund expense" and unequivocally answered the question of "whether it is currently feasible to quantify and record spreads, market impacts, and opportunity costs as a fund expense. We believe the answer is 'no.'" [25] Only after reaching this decision has the Commission proceeded with the formality of issuing a concept release asking for comment on disclosure of portfolio transaction costs, apparently for the purpose of considering any alternative other than full inclusion in the expense ratio.[26] Thus, without Congressional action, there is little doubt that the Commission will continue to require funds to use the

current, partial expense ratio. *Congress should require that funds include portfolio transaction costs in a total expense ratio.*

The Commission's position is inconsistent with its responsibility to provide the information that the marketplace needs to promote price competition. By requiring funds to use the partial expense ratio, the Commission is effectively forcing the public to choose funds based on the Commission's view of the proper measure of fund costs. The Commission's decision to second-guess the market by deciding for investors which kinds of information they are capable of understanding, contradicts basic market principles and is inconsistent with our capitalist system of free enterprise.

Investors logically look to the Commission to provide standardized reporting of expenses, and it is appropriate for the Commission to provide this service. But once the Commission has provided the important service of providing standardized information, it should remove itself from the market-driven determination of which information provides the best measure of a fund's true costs.

The Commission has argued that including portfolio transaction costs might distort fund managers' behavior.[27] As noted above, this is not for the Commission to judge. The marketplace should decide which expense ratio—the partial expense ratio or a total expense that includes portfolio transaction costs—is the best measure of a fund's costs.

Furthermore, it is the partial expense ratio that distorts fund managers' and investors' behavior alike. The partial expense ratio distorts fund managers' behavior by not holding them accountable for their decisions to spend a substantial amount of fund assets on trading securities.

As illustrated in Exhibit A, for example, the Commission believes that investors should only be told that the expense ratio for the PBHG Large Cap Fund is 1.16 percent, and that they should not be told that when commissions and spread costs are included, the Fund's expense ratio is 8.59 percent.[28] The true cost of that Fund is more than seven times the amount shown in the Commission's expense ratio! How can it be in the best interests of investors or consistent with free market economics to require, much less permit, the Fund to show its total costs of 1.16 percent? The partial expense ratio is misleading because it impliedly represents, in conjunction with other shareholder expenses listed in the fee table, the total cost of fund ownership.

The data in Exhibit A does not reflect outliers, but randomly selected examples from funds with more than $100 million in assets. If smaller funds with high turnover were considered, the differentials would be so large as to render the Commission's partial expense ratio fraudulent. For example, Lipper reports that the Rydex Telecom Fund's commissions for the fiscal year ending March 31, 2003, equaled 8.04 percent of assets. By applying the Zero Alpha Group study's methodology of estimating spread costs, we can estimate that total spread costs during that period equaled 8.75 percent of assets. Thus, whereas the Commission tells us that the Rydex Telecom Funds are only 1.37 percent, its true costs are 18.16 percent, or 13 times higher.[29] The Commission's partial expense ratio distorts investors' behavior because investors obviously would make different investment decisions if they knew the true costs of owning certain funds.

The Commission's partial expense ratio also distorts managers' behavior because it creates an incentive for them to pay for nonexecution expenses with fund commissions. Under current law, fund managers can pay higher commissions—that is, more than it would cost merely to execute the fund's trades—in return for nonexecution services. By paying for these nonexecution services with commissions, or what are known as soft dollars, fund managers effectively move these costs out of the expense ratio where they belong. This enables the fund that uses soft dollars to show a lower partial expense ratio than a fund that does not—even if the fund managers use identical services and have identical operating expenses. The Commission itself has conceded that "[t]he limited transparency of soft-dollar commissions may provide incentives for managers to misuse soft-dollar services."[30]

Furthermore, the nondisclosure of portfolio transaction costs exacerbates the conflict of interest that is inherent in the payment of soft dollars. As the Commission has recognized,

> [s]oft dollar arrangements create incentives for fund advisers to (i) direct fund brokerage based on the research provided to the adviser rather than the quality of execution provided to the fund, (ii) forego opportunities to recapture brokerage costs for the benefit of the fund, and (iii) cause the fund to overtrade its portfolio to fulfill the adviser's soft-dollar commitments to brokers.[31]

The continued concealment of portfolio transaction costs permits the soft-dollar conflict to operate virtually unchecked by market forces, whereas including portfolio

transaction costs in a total expense ratio would, at least, permit the marketplace to judge the efficacy of soft-dollar arrangements. If Congress does not take steps to eradicate soft dollars, at least it can require that these costs be disclosed so that the market can reach its own judgments regarding their efficacy.

Dollar Disclosure of Fees

Under current disclosure rules, funds are not required to disclose to investors how much they pay in fees. Many other financial services documents show investors exactly how much they are paying the service provider, including bank statements, insurance bills, credit card statements, mortgage loans, and a host of other documents. But mutual funds provide only an expense ratio (and a partial one, at that, see *supra*) and the dollar amount of a hypothetical account.

Congress should require that funds provide individualized dollar disclosure of fund expenses in shareholder statements, as proposed by the Government Accounting Office.[32] This requirement is necessary for two reasons. First, although the expense ratio is appropriate for providing comparability across different funds, it does not pack the same import as a dollar amount. Providing investors with the amount in dollars that they actually spent will give concrete form to an indefinite concept and make investors consider more fully the costs of different investment options.

Second, placing the dollar amount of expenses in the shareholder statement will direct shareholders' attention to the actual costs of fund ownership. No document is more likely to be read than a shareholder statement that shows the value of the shareholder's account and transaction activity during the period. Whereas the prospectus and shareholder report typically go directly from the mailbox to the trash can, even the most uninformed investors normally open their statements to check on the status of their accounts. There is no better way to draw shareholders' attention to the costs of investing than to require that the dollar amount of fees for the period be disclosed next to the value of the investor's account.

Some members of the fund industry have opposed informing investors about the actual costs of their fund investments on the grounds that doing so would be too costly and might mislead investors.[33] It appears that MFS Investment Management, the 12th largest mutual fund manager in America, disagrees. Earlier this month, MFS announced that it would begin providing fund shareholders with a quarterly statement of their actual fees.[34]

The Commission opposes disclosure of shareholders' actual costs and opposes including dollar disclosure in shareholder statements. The Commission recently concluded its consideration of a proposal to require funds to disclose individualized costs in shareholder statements by expressly rejecting both concepts. Instead, the Commission decided to require disclosure of the hypothetical fees paid on a $1,000 account in the shareholder report, despite the facts that the hypothetical fees paid on a $10,000 account are already disclosed in the prospectus, and shareholders who most need to have their attention directed to the fees that they pay are least likely to read the shareholder report. *In view of the Commission's, express opposition to effective disclosure of actual fees paid by shareholders, shareholders will receive disclosure of their actual fees in shareholder statements only if Congress requires funds to provide that information.*

Fee Comparisons

Congress should take additional steps to promote price competition in the mutual fund industry by requiring that funds disclose fees charged by comparable funds and, for managed funds, the fees charged by index funds. Without any context, current fee disclosure provides no information about whether a fund's fees are higher or lower than its peers. Current disclosure rules also do not show the premium paid to invest in a managed funds as opposed to an index fund. Requiring comparative information in the fee table would enable investors to consider a fund's fees in context and evaluate how they compare to fees across the industry.

Distribution Fees

The Commission currently requires that 12b–1 fees be disclosed on a separate line that describes those fees as "distribution fees." It does not require that the fee table show the amount spent on distribution by the fund manager out of its management fee. This is inherently misleading, as investors often use the presence of 12b–1 fees as a negative screen that they use to avoid paying any distribution fees. In fact, investors in non-12b–1 fee funds may actually pay as much or more in distribution expenses than some investors in 12b–1 fee funds.[35]

Congress should overrule the Commission's position and require that, if distribution fees are stated separately in the fee table, they must reflect all distribution expenses paid by a fund, directly or indirectly. Alternatively, Congress should require that fund expenses be displayed in a pie chart that shows how much of a fund's

fees were spent on each type of service. The Commission's current fee table is misleading and understates the amount of fund assets spent on distribution.

SOFT DOLLARS

Congress should ban soft dollars. The term "soft dollars" generally refers to brokerage commissions that pay for both execution and research services. The use of soft dollars is widespread among investment advisers. For example, total third-party research purchased with soft dollars alone is estimated to have exceeded $1 billion in 1998.[36] An executive with American Century Investment Management has testified that the research component of soft-dollar commissions costs six times the value of the execution component.[37]

Soft-dollar arrangements raise multiple policy concerns. The payment of soft dollars by mutual funds creates a significant conflict of interest for fund advisers. Soft dollars pay for research that fund advisers would otherwise have to pay for themselves. Advisers therefore have an incentive to cause their fund to engage in trades solely to increase soft-dollar benefits.[38]

Soft-dollar arrangements normally would be prohibited by the Investment Company Act because they involve a prohibited transaction between the fund and its adviser.[39] Section 28(e) of the Securities Exchange Act, however, provides a safe harbor from the Investment Company Act for soft-dollar arrangements as long as the brokerage and research services received are reasonable in relation to the amount of the commissions paid.

The conflicts of interest inherent in soft-dollar arrangements are exacerbated by current disclosure rules. The amount of fund assets spent on soft dollars is not publicly disclosed to shareholders, so they are unable to evaluate the extent, and potential cost, of the adviser's conflict.

Current disclosure rules reward advisers for using soft dollars because this practice creates the appearance that a fund is less expensive. The expense ratio does not include commissions, which gives advisers an incentive to pay for services with soft dollars, thereby enabling them to lower their management fees and the fund's expense ratio. Advisers can effectively reduce their expense ratios by spending more on soft dollars, while the fund's actual net expenses remain unchanged.

Finally, current disclosure rules may encourage excessive spending on soft dollars. Advisers would tend to spend less on soft dollars if they knew that they would be held publicly accountable for their expenditures.

The Commission has frequently recognized but declined to address the problem of soft dollars. As discussed above, the Commission is opposed to including portfolio transaction costs in funds' expense ratios, which would have the benefit of enabling the market to determine for itself the efficacy of soft-dollar arrangements. The Commission previously proposed a rule that would require that soft-dollars costs be quantified, but decided against adopting it.[40] When the Commission staff last evaluated soft-dollar arrangements in 1998, it concluded that additional guidance was needed in a number of areas.[41] For example, the staff found that many advisers were treating basic computer hardware—and even the electrical power needed to run it—as research services qualifying under the Section 28(e) safe harbor.[42] The staff recommended that the Commission issue interpretive guidance on these and other questionable uses of soft dollars, but it has failed to do so.

In fact, the only formal action that the Commission has taken in recent years is to *expand the use of soft dollars.* In December 2001, the Commission took the position that the safe harbor should apply to markups and markdowns in principal transactions, although Section 28(e) expressly applies only to "commissions."[43] This position directly contradicts not only the plain text of the statute, but also the position taken by the Commission in 1995 that Section 28(e) "does not encompass soft-dollar arrangements under which research services are acquired as a result of principal transactions."[44] Although the Commission has, once again, suggested that it intends to narrow the scope of soft dollars, its recent history suggests that Congressional action is necessary. *In any case, the Commission lacks the authority to ban soft dollars.*

There is no better evidence that the time has come to ban soft dollars than the recent recognition of the insidious nature of this practice by members of the fund industry. Earlier this month, MFS Investment Management announced that it has ceased the payment of soft dollars.[45] The chairman of the board of the Putnam Funds, America's 6th largest fund complex, recently announced that the Funds intended to severely restrict the use of soft dollars and to consider a complete ban.[46] Vanguard, the Nation's second largest fund complex, has traditionally shunned soft dollars.[47] American Century, the Nation's third largest fund complex, uses soft dollars only for research, and not for other nonexecution services.[48]

The explanations provided by fund directors and executives reflect the insidious nature of soft dollars. In addressing the fact that soft dollars enable fund managers to use the fund's money to pay for research used by the manager, the independent chairman of the Putnam Funds stated that "[t]he best decisions get made when you buy services with your own money." [49] Similarly, MFS' Chairman, Robert Pozen,

> Sees the soft-dollar funnel as a lucrative one for brokers, but one that hides the true cost of such services to shareholders. "It is all camouflaged," said Mr. Pozen, a former Associate General Counsel of the SEC. Now, he added, "If we want something, if we think it is valuable, we will pay cash." [50]

A Fidelity executive acknowledged the procompetitive advantage of a ban on soft dollars, stating: "[w]e do not rule out a competitive environment through which all research is acquired through cash rather than commissions." [51]

The difficulty for fund firms, however, is that without a statutory ban on soft dollars they may suffer a competitive disadvantage MFS estimates that paying for its own research will reduce its advisory fees.[52] Fidelity estimates that of the $1.1 billion in commission it paid in 2003, $275 million paid for soft-dollar research.[53] It is unrealistic to expect these fund managers to maintain the high road at the expense of reduced advisory fees, while other fund managers continue to pay their own research expenses through soft dollars rather than out of their own pockets.

DISTRIBUTION

12b–1 Fees and Revenue Sharing

When Congress enacted the Investment Company Act of 1940, it expressly prohibited fund managers from using fund assets to finance the distribution of the fund's shares. Section 12(b) of the Act recognized the inherent conflict of interest between the manager's desire to increase fund assets in order to increase its fees on the one hand, and the fund's desire to hold down costs on the other hand. Unfortunately, the policy underlying Section 12(b) has long been abandoned, as fund assets are used for a wide range of distribution expenses that benefit fund managers at the expense of fund shareholders.

The policy of separating the product from its distribution was first abandoned by the Commission when, after a prolonged review, it adopted Rule 12b–1 in 1980.[54] In the 1970's, mutual funds experienced periods of net redemptions that prompted fund managers to lobby the Commission to permit the use of fund assets to finance the distribution of the funds' shares.[55] Fund managers argued that net redemptions resulted in increased costs and that the financing of distribution by the fund would help reduce or eliminate net redemptions.[56]

The Commission initially rejected these arguments,[57] but ultimately relented, provided that certain conditions were observed. For example, the Commission required that the fund's independent directors approve the 12b–1 plan.[58] Among the factors the Commission said a fund's directors should consider when evaluating whether to adopt or renew a 12b–1 plan was the plan's effectiveness in remedying the problem that it was designed to address, for example, increased costs resulting from net redemptions.[59]

The Commission's most significant concern regarding 12b–1 fees was the conflict of interest that they created between the fund and its adviser.[60] The Commission feared that 12b–1 fees would result in higher advisory fees and the fund's adviser would not share the benefits of asset growth.[61] Some would argue that this is precisely what has happened, with any growth-based economies of scale realized from 12b–1 fees being pocketed by fund managers and not shared with fund shareholders.[62]

Of course, this analysis goes primarily to the use of 12b–1 fees for marketing the fund, which is what Rule 12b–1 was intended to permit. It does not address the ways in which 12b–1 are actually used today and that were wholly unanticipated by the Commission when Rule 12b–1 was adopted. According to the Investment Company Institute, only 5 percent of 12b–1 fees are spent on advertising and sales promotion, whereas 63 percent of 12b–1 fees are spent on broker compensation.[63]

The use of fund assets to compensate brokers is precisely what Section 12(b) was intended to prohibit. This practice puts the fund squarely in the position of underwriting its own securities. The fund's assets are used to incentivize brokers to recommend the fund over competing funds. The lesser the quality of the fund, the greater the pressure on the fund and its manager to pay brokers more to sell the fund.

This irreconcilable conflict is mirrored on the distribution side of the business. When brokers are paid by the funds, rather than their customers, they have an incentive to recommend the fund that offers the biggest payout, rather than the fund

that will provide the best investment for their customers.[64] There is another incentive for brokers to favor arrangements whereby they are compensated by funds, and that is the fact that the compensation from the fund is not transparent. Whereas the payment of a front-end load is relatively evident to the investor, the payment of a 12b–1 fee is not. It is even less clear that the already opaque 12b–1 fee is ending up in the broker's pocket. For this reason, brokers and investors have begun to favor classes of fund shares where the broker is compensated by the fund, regardless of whether that class is in the best interests of shareholders.[65]

Thus, the Commission has created a distribution compensation structure that is directly at odds with the interests of investors and the Investment Company Act. Rather than tying brokers' compensation to their relationships with their customers, where the Investment Company Act requires that it be placed, the Commission has tied brokers' compensation to their relationships with the funds, where the Investment Company Act expressly forbade its placement.

Congress should reaffirm the supremacy of Section 12(b) and prohibit funds from compensating brokers for selling fund shares. Although this will necessarily entail the repeal of Rule 12b–1, it will in no way limit the ways in which investors can choose to pay their brokers. It will simply require that however brokers are compensated—through a front-end load, back-end load, level-load, or any combination thereof—they are compensated by their customers, not by the funds. Thus, if a customer chooses to pay his broker on an installment basis, at 0.50 percent each year, for example, that amount would be paid by the customer directly or deducted from his fund account.

In addition, Congress should prohibit fund managers from compensating brokers in connection with the purchase or sale of fund shares. For decades, the Commission has permitted fund managers to circumvent the prohibition against fund assets being used for distribution by endorsing the fantasy that managers' payments to brokers are made out of the managers' "profits," and not out of the fees they receive from the funds.[66]

One might argue that, to maintain perfect legislative coherence, Congress should also prohibit fund managers from paying for distribution that is not connected to sales and purchases, that is, distribution that does not compensate the broker for distribution services provided to its customer. I disagree. The conflict is substantially reduced in this situation because the fund manager's and the fund's interests are generally aligned. General marketing payments do not create a direct incentive for brokers to favor one fund group over another. General marketing does what advertising for decades has been shown to do: Promote competition. Indeed, by locating these payments in the management fee, the manager will be spending its own money and accordingly will have an incentive to minimize costs. With an express requirement that independent fund directors evaluate the efficacy of fund manager expenditures on marketing and determine that resulting economies have been shared with fund shareholders, expressly permitting fund managers to use the management fee to pay for marketing would be appropriate.

Misleading Fund Share Classes

Mutual funds often offer several classes of shares that reflect different ways of paying for distribution services. Typically, Class A shares carry a front-end load, Class B shares a back-end load, and Class C shares carry a level load. An investor is usually better off buying Class A shares if he intends to hold his shares for the long-term, and Class C shares if he may sell in the short-term. When Class B shares are best option, it is for the shareholder who holds for the mid-term. In some cases there is virtually no shareholder for whom Class B shares are the best option.[67]

The Commission does not prohibit funds from offering Class B shares, even when there is no shareholder for whom Class B shares could be the best investment option. The Commission even rejected a rule amendment that would have required that funds illustrate in the prospectus the relative costs of each class of shares. Following the Commission's lead, a court held in January 2004 that, even assuming that there was no rational investor for whom Class B shares would be the best investment, the fund had no duty to disclose this fact in the prospectus.[68]

It is unconscionable that under current Commission positions a fund can offer a class of shares that would not be the best investment for any rational investor. Congress should require that multiclass funds illustrate, in a graphic format, the costs of investing in different classes over a 15-year period. In addition, Congress should require that the fund's independent directors find, subject to a fiduciary duty as described above, that each class of shares offered could be a reasonable investment alternative.

FUND ADVERTISING

Throughout the late 1990's, the Commission frequently berated the fund industry for misleading investors by advertising short-term performance.[69] Funds with short life-spans routinely advertised 1 year, sometimes even 2- and 3-year annualized investment returns in excess of 100 percent. With the crash of the stock bubble in 2000, the Commission's concerns were validated, as many of these funds experienced huge losses, in some cases in excess of 70 percent of their value.

The Commission's actions have not reflected its words, however. In September 2003, the Commission adopted advertising rules that utterly failed to address the very problems that it had identified in the late 1990's.[70] The rules require funds to provide a telephone number or web address where current performance information is available, as if the problem with short-term performance was that it wasn't current enough. The Commission also required that the text in fund ads include the statement that "current performance may be higher or lower than the performance data quoted."

Recent fund advertisements have demonstrated the inadequacy of the Commission's new rules. After 3 years of negative returns, stock funds had a banner year in 2003. Many of those funds are now advertising their stellar 1-year performance without any disclosure of their poor returns in 2000, 2001, and 2002. Because they are required only to show their 1-, 5- and 10-year returns, the negative returns of 2000 to 2002 are hidden from view. The ads create a misleading impression by showing the outsized returns of 2003 without any mitigating disclosure of the down years that preceded them and the performance volatility that those years' returns illustrate.

For example, one ad shows SEC-mandated performance for four funds, each of which experienced superior returns in 2003, but experienced losses or substantially lower performance in each year from 2000 to 2002. As illustrated in the table below, the disclosure of each fund's annual performance in the years preceding 2003 would have presented a very different, far more accurate picture. The Commission's rulemaking has done nothing to prevent such misleading ads, which have appeared routinely in business and personal finance magazines in the first few months of this year.

Funds	**Disclosed***	**Not Disclosed****		
	2003	**2002**	**2001**	**2000**
Fund No. 1	51.68 percent	(21.27 percent)	(7.56 percent)	(18.10 percent)
Fund No. 2	42.38 percent	(9.37 percent)	(12.99 percent)	(8.96 percent)
Fund No. 3	23.36 percent	(20.44 percent)	(3.74 percent)	12.25 percent
Fund No. 4	29.96 percent	(17.16 percent)	(5.02 percent)	8.54 percent

**Source:* Business 2.0 (March 2004).
***Source:* Fund Prospectuses.

The Commission's rulemaking also did nothing to address the problem of the disconnect between the advertised performance of funds and the actual returns experienced by shareholders. As confirmed by a recent DALBAR study, "[i]nvestment return is far more dependent on investment behavior than on fund performance."[71] DALBAR found that the average equity fund investor earned *2.57* percent annually over the last 19 years, in comparison with the S&P 500's *12.22* percent annual return during the same period. This translates into a cumulative return for the S&P 500 of *793.34* percent from 1984 to 2002, compared with equity fund investors' actual cumulative return of *62.11* percent during the same period.

These stunning and disheartening data illustrate, in part, a failure of investor education and individual choice. Investors have consistently chased the best performing funds just before they crashed, and dumped the worst performing funds just before they recovered. This sell-high, buy-low mentality is only encouraged by the Commission's current approach to fund performance advertising, which permits funds to present outsized returns with no meaningful caveats regarding their volatility and the likelihood that performance will soon revert to the mean.[72]

Not only do current rules fail to require meaningful disclosure about the volatility of fund returns, but they also fail to place outsized, 1-year returns in the context of the market as a whole. To illustrate, the performance of the S&P 500 for 2003 was 28.68 percent, which puts the 51.68 percent return of the fund cited above in a light very different (albeit still positive) from one in which the performance data stands alone. The fund's advertised 10-year return of 10.58 percent would tell a dif-

ferent story if it were required to be juxtaposed against the S&P 500's 11.07 percent 10-year return.

The Commission also has recognized the need for investment returns to be considered in the context of fees, yet its rules do virtually nothing to benefit investors in this respect. In its proposing release, the Commission promised that its new rule would "ensure that fund advertisements remind fund shareholders about the availability of information about fund charges and expenses." [73] Yet the final rule required only that fund advertisements refer investors to the prospectus for consideration of fund expenses, among other things.[74] In contrast, the NASD has proposed that fund advertisements include a box that shows both the fund's maximum sales charge and its expense ratio.[75]

Congress should require that fund advertisements include all information necessary to make the information presented not misleading. This must include, at a minimum, investment returns for each individual year where such returns differ materially from fund's 1-year performance, disclosure of the fund's total expense ratio (for example, including the fund's portfolio transaction costs) and sales charges, and the performance and expenses of a comparable index fund.

MISLEADING FUND NAMES

Funds are prohibited from using misleading names, yet the Commission has taken the position that a fund with "U.S. Government" in its name can invest 100 percent of its assets in Fannie Mae or Freddie Mac securities.[76] These securities are not guaranteed by the U.S. Government, which is the guarantee investors reasonably believe they are getting when they invest in Government securities. *Congress should prohibit funds from using names that imply that they invest in U.S. Government securities unless at least 80 percent of the funds' assets are actually invested in securities that are backed by the full faith and credit of the U.S. Government.*

Commission Initiatives

As discussed above, there many areas where Congressional action is needed either because the Commission lacks the necessary authority or opposes mutual fund reforms. In other areas, however, the Commission has taken strong steps to address problems in the mutual fund industry, in some cases over the objections of certain Commissioners. None of these initiatives has taken the form of final rules, and the Committee accordingly should continue to encourage the Commission to proceed with these rulemaking proposals to ensure they do, in fact, become law. Fund Democracy strongly supports the Commission's efforts in each of these areas.

DIRECTED BROKERAGE

Many fund managers compensate brokers for selling fund shares with fund brokerage. Under these arrangements, the fund manager pays the broker through commissions received in connection with a fund's portfolio transactions.[77] This practice increases funds' portfolio transaction costs while reducing the amount the fund manager might otherwise spend on distribution, thus creating a significant conflict of interest. The Commission has proposed to prohibit fund managers from considering sales of fund shares when selecting brokers to effect fund transactions.[78] Fund Democracy expects to file detail comments generally supporting this proposal.

DISCLOSURE OF BROKERS' COMPENSATION

For virtually all securities transactions other than purchases of mutual fund shares, investors receive a transaction confirmation that shows how much the broker was paid in connection with the transaction. Permitting brokers to hide their compensation on the sale of mutual funds has spawned a Byzantine and harmful array of selling arrangements, including revenue sharing (also known as payments for shelf space), directed brokerage, and noncash compensation.

Mutual fund shareholders should be entitled to receive the same information as other investors in securities in the form of full disclosure of their brokers' compensation on fund transaction confirmations. Such disclosure also should show how breakpoints applied to the transaction, as well as any special compensation received by brokers for selling particular funds.

Brokers also should be required to provide, at or before the time the investor places the order, an estimate of compensation to be received by the broker in connection with the transaction and the total costs of investing in the fund. When buying a house, purchasers are provided with an estimate of their total closing costs before making a final decision. As discussed immediately above, however, fund shareholders do not even receive a final statement of their actual costs, much less an up-front estimate of such costs.

The Commission has proposed to require brokers to provide, both at the point-of-sale and in the transaction confirmation, disclosure of the costs and conflicts of in-

terest that arise from the distribution of mutual fund shares.[79] Fund Democracy expects to file comments with the Commission generally supporting its proposal.

MANDATORY REDEMPTION FEE

The most substantial losses resulting from the current mutual fund scandal were caused by funds' selling their shares at inaccurate or stale prices and allowing certain investors to trade rapidly in and out of the fund to take advantage of those pricing discrepancies. Some academics who have studied the issue have estimated that this practice costs long-term fund shareholders billions of dollars each year. Funds are already required to price their shares accurately, and this requirement should be more strictly enforced. To the extent that pricing is not a perfect science, however, some funds still may use slightly inaccurate prices that sophisticated traders can identify and exploit.

These opportunities would be eliminated by the imposition of a small redemption fee on all sales of fund shares occurring within a short time period after the purchase. The Commission has proposed to require "funds (with certain limited exceptions) to impose a 2 percent redemption fee on the redemption of shares purchased within the previous 5 days."[80] In all cases, the redemption fee would be payable to the fund, so that shareholders would receive the benefits. Fund Democracy expects to file comments with the Commission generally supporting its proposal.

HARD 4 P.M. CLOSE

In connection with the current mutual fund scandal, some mutual fund companies apparently conspired to allow late trading in their funds. Others were the victims of brokerage firms and other trade processing intermediaries who assisted their clients in evading those restrictions. Steps must be taken to better prevent evasion of the late trading restrictions, including tough sanctions against those who knowingly violate or aid their clients to violate those restrictions. In addition, the quality of compliance systems at both the funds and the trade processing intermediaries must be upgraded to ensure detection of these and other abuses and to allow an effective regulatory inspection of those procedures.

The Commission has proposed to require that orders to purchase fund shares be received by the fund, its designated transfer agent, or a registered securities clearing agency no later than the time at which the fund is priced.[81] This is known as a "Hard 4 p.m. Close" because most funds price their shares at 4 p.m. Eastern Time. Fund Democracy and the Consumer Federation of America have submitted joint comments to the Commission generally in support of its efforts to prevent late trading of mutual fund shares.

PORTFOLIO MANAGER COMPENSATION

In some cases, a portfolio manager's compensation or fund investments may not align his or her interests with the interests of fund shareholders. For example, a fund portfolio manager who also manages a hedge fund or other private accounts may have an incentive to favor those accounts over the mutual funds.[82] The highest-paid executives of operating companies are required to disclose their compensation and their trades in company stock, yet there is no comparable requirement for mutual funds.

Recent revelations have included investments by portfolio managers that are harmful to shareholders' interests. The Commission has proposed that fund managers be required to disclose the structure of their compensation and their investments in the funds they manage.[83] Fund Democracy expects to file comments with the Commission generally supporting this proposal.

Exhibit A
from Jason Karceski, Miles Livingston & Edward O'Neal, Mutual Fund Brokerage Commissions (Jan. 2004)

Exhibit 2: Total 2001 costs of investing: 4 representative large equity funds

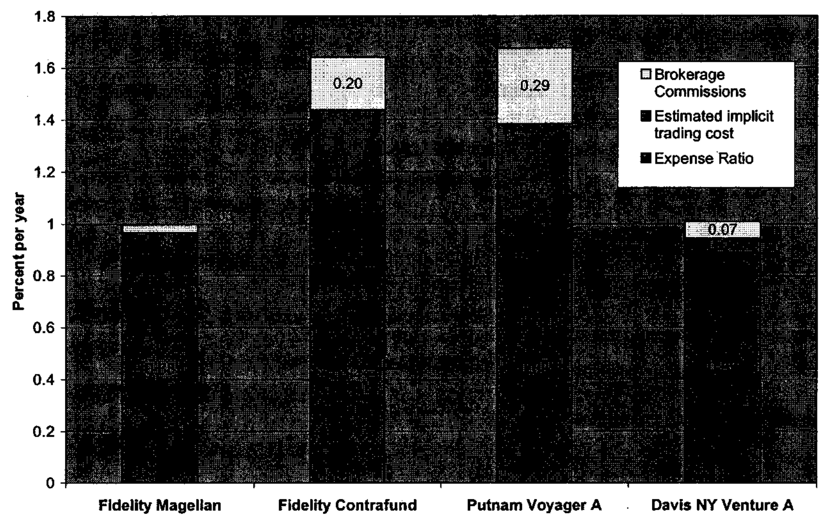
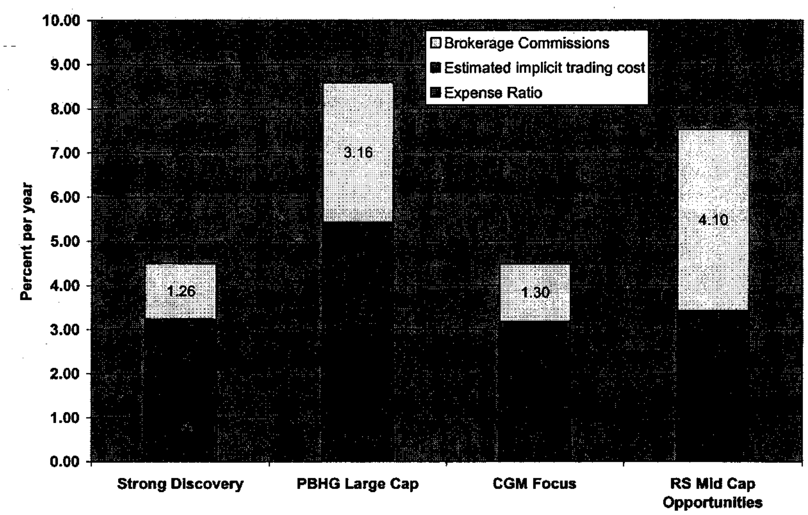


Exhibit 3: Total 2001 costs of investing in high turnover equity funds with total net assets greater than $100 Million



ENDNOTES

[1] I wish to thank the assistance of Thomas Walker and Milo Mitchel in the preparation of this testimony.

[2] Testimony before the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, Committee on Financial Services, U.S. House of Representatives (November 6, 2003) and Testimony before the Subcommittee on Financial Management, the Budget, and International Security, Committee on Governmental Affairs, U.S. Senate (November 3, 2003).

[3] T3See Marcy Gordon, Accounting Oversight Official pledges "tough love" *Kansas City Star* (November 21, 2003) (William McDonough, Chairman of the Public Company Accounting Oversight Board, suggesting that a similar agency may be needed for the mutual fund industry).

[4] *See* Bearing of Distribution Expenses by Mutual Funds, Investment Company Act Rel. No. 11414 (October 28, 1980) (adopting Rule 12b–1).

[5] *See, e.g.,* Report on Mutual Fund Fees and Expenses, Division of Investment Management, Securities and Exchange Commission, Part IV.B.2 (December 2000) (recommending that the Commission issue new guidance to fund directors regarding the review and approval of 12b–1 plans).

[6] The Board would supplement, and not in any way supplant, the SEC's authority over mutual funds. In the event of any disagreement between the SEC and the Board, the SEC would have final decision making authority.

[7] *See, e.g., SEC* v. *Columbia Management Advisors, Inc. and Columbia Funds Distributor, Inc.,* Civil Action No. 04 CV 10367–GAO (D. Mass., February 24, 2004); *SEC* v. *Mutuals.Com, Inc., Connely Dowd Management, Inc., Mtt Fundcorp, Inc., Richard Sapio, Eric McDonald, and Michele Leftwich,* Civil Action No. 303 CV 2912D (N.D. Tex., December 4, 2003); *SEC* v. *Invesco Funds Group, Inc., and Raymond R. Cunningham,* Civil Action No. 03–N–2421 (PAC) (D. Col., December 2, 2003); *SEC* v. *Millennium Capital Hedge Fund, L.P., Millennium Capital Group, LLC, and Andreas F. Zybell,* Civil Action No. CV–03–1862–PHX–FJM (D. Ariz., December 2, 2003); *SEC* v. *Security Trust Company, N.A., Grant D. Seeger, William A. Kenyon and Nicole McDermott,* Civil Action No. CV 03–2323 PHX JWS (D. Ariz., November 25, 2003); *SEC* v. *Gary L. Pilgrim, Harold Baxter and Pilgrim Baxter & Associates, Ltd.,* Civil Action No. 03–CV–6341 (E.D. Penn., November 20, 2003); *SEC* v. Justin M. Scott and Omid Kamshad, Civil Action No. 03–12082–EFH (D. Mass., October 28, 2003); *In the Matter of Massachusetts Financial Services Co., John W. Ballen and Kevin R. Parke,* Investment Company Act Rel. No. 26347 (February 5, 2004); *In the Matter of Paul A. Flynn,* Investment Company Act Rel. No. 26345 (February 3, 2004); *In the Matter of Alliance Capital Management, L.P., Investment Company Act Rel. No. 26312 (December 18, 2003); In the Matter of James Patrick Connelly, Jr.,* Investment Company Act Rel. No. 26209 (October 16, 2003); *In the Matter of Theodore Charles Sihpol, III,* Administrative Proceeding File No. 3–11621 (September 16, 2003). None of the individuals named in these complaints was an independent fund director.

[8] The Commission and Attorney General for the State of New York reported that they had reached a settlement with Bank of America in which "Bank of America has also agreed to implement certain election and retirement procedures for the Nations Funds trustees that will result in the replacement of the Nations Funds trustees within 1 year." SEC Press Release 2004–33 (March 15, 2004); *see* Press Release, New York Attorney General (March 15, 2004) ("Under a specific provision of the agreement, eight members of the Board of Directors of Nations Funds, BOA's mutual fund complex, will resign or otherwise leave the board in the course of the next year"); *see also* Beth Healy, Pressure to Quit Riles Trustees, Boston Globe (March 17, 2004) ("Under the deal, Bank of America promised the regulators it would 'use its best efforts' to persuade 8 of the 10 Nations Funds directors to leave the board by May 1, 2005, . . ."). Bank of America does not have the legal authority to set procedures for the board of the Nations Funds, however, and suggesting that Bank of America has such authority effectively undermines the principle that a fund's board is independent of the fund manager. *See* Yuka Hayashi, Directors' Treatment In Bk Of Amer Settlement Causes Stir, *Wall Street Journal* (March 19, 2004) (quoting Allan Mostoff, President of the Mutual Fund Directors Forum: "I think a lot of people are confused.") The Nations Funds trustees reportedly have denied that they plan to give up their positions, thereby suggesting that not even this *de minimis* "penalty" will stand. *See* Healy, *supra* (directors may fight agreement to by Bank of America); Christopher Oster & Tom Lauricella, Bank of America Likely Will Face Trustees' Review, *Wall Street Journal* (March 19, 2004) (same); *see generally* Mark Boslet, Spitzer Reiterates Vow To Watch Mutual Fund Board Members, *Wall Street Journal* (March 19, 2004).

[9] *In the Matter of Jon D. Hammes, Albert Gary Shilling, Allan H. Stefl, and Linda F. Stephenson,* Investment Company Act Rel. No. 26290 (December 11, 2003).

[10] *Id.* (dissent of Commissioner Roel C. Campos).

[11] I am aware of two cases that the Commission has brought under Section 36(b), neither of which involved an excessive fees claim. *See In the Matter of American Birthright Trust Management Company, Inc.,* Litigation Rel. No. 9266, 1980 SEC LEXIS 26 (December 30, 1980); *SEC* v. *Fundpack, Inc.,* No. 79–859, 1979 WL 1238 (D.D.C., August 10, 1979).

[12] Investment Company Act Section 36.

[13] For example, my research assistant was able to identify 18 funds in Morningstar's database with expense ratios in excess of 5 percent, yet the average management fee for these funds was only 1.06 percent, and only one fund's expense ratio exceeded 1.29 percent.

[14] *See, e.g.,* Letter from Senator Daniel Akaka, Representative Richard Baker, Senator Peter Fitzgerald, Senator Carl Levin, and Representative Michael Oxley to William Donaldson, Chairman, Securities and Exchange Commission (March 11, 2004); Letter from Representative Richard Baker and Representative Michael Oxley to William Donaldson, Chairman, Securities and Exchange Commission (July 30, 2003); Investment Company Governance, Investment Company Act Release No. 26323 (January 15, 2004); Testimony, *supra* note 2; Letter from Mercer Bullard to Richard Baker, Chairman, and Paul Kanjorski, Ranking Member, Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, Financial Services Committee (July 9, 2003).

[15] *See* Investment Company Governance, *id.*

[16] *Id.*

[17] If the Commission could really impose "requirements" in this way, then it could effectively rewrite the entire Investment Company Act simply by amending the Exemptive Rules and enact every reform discussed in this testimony, but the Commission has expressly conceded that its authority is not so broad. *See, e.g.,* Ian McDonald, SEC's Roye Wades Through New Rules for Mutual Funds, *Wall Street Journal Online* (March 19, 2004) (interview with Paul Roye, Director, SEC Division of Investment Management, in which he acknowledges that the Commission does not have the authority to ban soft dollars).

[18] Investment Company Governance, *supra* note 14.

[19] Shareholder Reports and Quarterly Portfolio Disclosure of Registered Management Investment Companies, Investment Company Act Release No. 25870, Part I.B (December 18, 2002).

[20] *Id.* (citing a joint report of the Commission and the Office of the Comptroller of the Currency that "found that fewer than one in five fund investors could give any estimate of expenses for their largest mutual fund and fewer than one in six fund investors understood that higher expenses can lead to lower returns").

[21] Concept Release at Part I (citing John M.R. Chalmers, Roger M. Edelen, Gregory B. Kadlec, *Fund Returns and Trading Expenses: Evidence on the Value of Active Fund Management,* at 10 (August 30, 2001) (available at *http://finance.wharton.upenn.edu/edelen/PDFs/MF_tradexpenses.pdf*). "These estimates *omit the effect of market impact and opportunity costs,* the magnitude of which may exceed commissions and spreads." *Id.* [Emphasis added].

[22] *See* Jason Karceski, Miles Livingston & Edward O'Neal, Mutual Fund Brokerage Commissions at 9 (January 2004) (available at *http://www.zeroalphagroup.com/headlines/ZAG_mutual_fund_true_cost_study.pdf*). Exhibit A to this testimony shows the expense ratios, brokerage commissions, and spread costs for total costs for eight of the funds studied.

[23] *See* Sara Hansard, Lipper Data Miffs Some Firms, Investment News at 3 (February 23, 2004) (173 funds paid commissions in excess of 0.99 percent of net assets, which is the dollar-weighted average expense ratio for equity funds).

[24] Memorandum from Paul F. Roye, Director, Division of Investment Management, Securities and Exchange Commission to William H. Donaldson, Chairman, Securities and Exchange Commission, (June 3, 2003) (available at *http://financialservices.house.gov/media/pdf/02-14-70%20memo.pdf*) (Donaldson Memorandum).

[25] *Id.* at 28 & 30.

[26] *See* Request for Comments on Measures to Improve Disclosure of Mutual Fund Transaction Costs, Investment Company Act Rel. No. 26313 (December 19, 2003) (Concept Release).

[27] *See, e.g.,* Donaldson Memorandum at 30–31, *supra* note 24.

[28] Exhibit A also shows that, when commissions and spread are included, the expenses of the Strong Discovery Fund rise from 1.50 percent to 4.50 percent, the CGM Focus Fund from 1.20 percent to 4.48 percent, and the RS Mid Cap Opportunities Fund from 1.47 percent to 7.52 percent.

[29] The Lipper data show that at least 31 funds' expense ratios would exceed 10 percent if they include commissions and spread costs.

[30] Concept Release at Part III.A, *supra* note 26.

[31] Donaldson Memorandum at 36, *supra* note 24. Regarding directed brokerage, the Commission recently stated: "We believe that the way brokerage has been used to pay for distribution involves unmanageable conflicts of interest that may harm funds and fund shareholders." Prohibition on the Use of Brokerage Commissions to Finance Distribution, Investment Company Act Rel. No. 26356 at Part II (February 24, 2004).

[32] Government Accounting Office, Mutual Funds: Information On Trends In Fees And Their Related Disclosure (March 12, 2003).

[33] *See, e.g.,* Testimony of Paul G. Haaga, Jr., Executive Vice President, Capital Research and Management Co. and Chairman, Investment Company Institute, before the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, Committee on Financial Services, U.S. House of Representatives, at 16–17 (June 18, 2003).

[34] MFS to Make Sweeping Reforms to Tell Investors About Fees, *Wall Street Journal Online* (March 16, 2004) ("'We want people to know that although we have had a difficult time lately, we will do whatever's necessary to put shareholders first,' [MFS Chairman Robert] Pozen said.").

[35] In 1999, Paul Haaga, Chairman of the Investment Company Institute and Executive Vice President of the Capital Research and Management Company, stated at an SEC roundtable: "The idea that investors should prefer the funds that do not tell what they are spending on distribution over the ones that do is nonsense. You know, if you are spending money on distribution, say it. If you are not spending money on distribution do not say it; but do not pretend that there are no expenses there for a fund that doesn't have a 12b–1 plan." Conference on the Role of Investment Company Directors, Washington, DC. (February 23 & 24, 1999) (Haaga was not ICI Chairman at this time).

[36] Inspection Report on the Soft-Dollar Practices of Broker-Dealers, Investment Advisers and Mutual Funds, Securities and Exchange Commission, at text accompanying note 1 (September 22, 1998).

[37] Testimony of Harold Bradley, Senior Vice President, American Century Investment Management, before the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, Committee on Financial Services, U.S. House of Representatives, at 5 (March 12, 2003).

[38] *Id.* at 2 (the statutory safe harbor permitting soft-dollars arrangements "encourages investment managers to use commissions paid by investors as a source of unreported income to pay unreported expenses of the manager").

[39] *See* Investment Company Act Section 17(e); Inspection Report at 38, *supra* note 36.

[40] Donaldson Memorandum at 13–17, *supra* note 24. Fidelity recently recommended that the Commission reconsider its decision not to require the quantification of soft-dollar costs. Ann Davis, Fidelity Wants Trading Costs to Be Broken Down, *Wall Street Journal* (March 15, 2004).

[41] Inspection Report on the Soft-Dollar Practices of Broker-Dealers, Investment Advisers and Mutual Funds, Securities and Exchange Commission, at text accompanying note 1 (September 22, 1998) ("Section 28(e) Report").

[42] *Id.* at Section V.C.4.

[43] Commission Guidance on the Scope of Section 28(e) of the Exchange Act, Exchange Act Rel. No. 45194 (December 27, 2001).

[44] Investment Advisers Act Release No. 1469 (February 14, 1995).

[45] John Hechinger, MFS Ends Soft Dollar System on Concerns over Ethics, *Wall Street Journal* (March 16, 2004).

[46] *Id.*

[47] *Id.*

[48] *Id.*

[49] *Id.* (quoting John Hill).

[50] *Id.*

[51] Landon Thomas, Jr., Mutual Fund Tells Wall Street It Wants à la Carte Commissions, *New York Times* (March 16, 2004).

[52] MFS Ends "Soft Dollar" System, *supra* note 35.

[53] Fidelity Wants Trading Costs to Be Broken Down, *supra* note 40.

[54] Bearing of Distribution Expenses by Mutual Funds, Investment Company Act Rel. No. 11414 (October 28, 1980) (adopting Rule 12b–1); Bearing of Distribution

Expenses by Mutual Funds, Investment Company Act Rel. No. 10862 (September 7, 1979) (proposing Rule 12b–1) ("12b–1 Release 10862"); Bearing of Distribution Expenses by Mutual Funds, Investment Company Act Rel. No. 10252 (May 23, 1978) (advance notice of rulemaking) ("12b–1 Release 10252"); Bearing of Distribution Expenses by Mutual Funds, Investment Company Act Rel. No. 9915 (August 31, 1977) (rejecting requests to permit funds to finance their distribution expenses) ("12b–1 Release 9915"). The Commission held public hearings on the bearing of distribution expenses by mutual funds on November 17, 18, 22 & 23, 1976. *See* Investment Company Act Rel. No. 9470 (October 4, 1976) (announcing hearings on appropriateness of funds' bearing their distribution expenses); *see also* Vanguard Group, Inc., *et al.,* Investment Company Act Rel. No. 9927 (September 13, 1977) (order of temporary exemption and notice and hearing on application for exemption to permit funds to bear their distribution expenses).

[55] 12b–1 Release 10252, *supra* n.3.

[56] 12b–1 Release 10252, *supra* at 1.

[57] *See* 12b–1 Release 9915.

[58] *See* Rule 12b–1(b)(2).

[59] *See* 12b–1 Release 10862, *supra* at 11–13 (when renewing a 12b–1 plan, the directors should consider "whether or not the plan was working as anticipated").

[60] *See* 12b–1 Release 10252, *supra* at 3; 12b–1 Release 10862, *supra* at 9. Indeed, the Dreyfus Corporation, a major fund complex, argued against Rule 12b–1 on the ground that that no amount of protections "could ameliorate the adviser's conflict of interest." 12b–1 Release 10862, *supra* at 6.

[61] *See* 12b–1 Release 10252, *supra* at 3 (proposing that the advisory fee be a fixed amount to prevent the adviser from confiscating benefits derived from 12b–1 fees); Donaldson Memorandum, *supra* at 70–71 ("When a fund bears its own distribution expenses, the fund's investment adviser is spared the cost of bearing those expenses itself, and the adviser benefits further if the fund's distribution expenditures result in an increase in the fund's assets and a concomitant increase in the advisory fees received by the adviser.").

[62] Report on Mutual Fund Fees and Expenses, at Part F, *supra* note 5 (noting funds whose assets exceed their highest breakpoint).

[63] Use of Rule 12b–1 Fees by Mutual Funds in 1999, Investment Company Institute, 9 Fundamentals 2 (April 2000). Funds spend the other 32 percent of 12b–1 fees on administrative services. *Id.*

[64] *See* Laura Johannes and John Hechinger, Conflicting Interests: Why a Brokerage Giant Pushes Some Mediocre Mutual Funds, *Wall Street Journal* (January 9, 2004); *see also In the Matter of Morgan Stanley DW Inc.,* Exchange Act Rel. No. 48789 (November 17, 2003).

[65] *See* Complaint, *Benzon* v. *Morgan Stanley,* No. 03–03–0159 (M.D. Tenn.).

[66] This has created the ludicrous situation, embodied in Commission positions, in which fund directors technically are prevented from reviewing the manager's payments to brokers. Under Section 36(b) of the Act, fund directors are supposed to consider the manager's profitability, which means that they must ignore distribution payments or risk being accused of reducing the manager's profitability to make the management fee seem more palatable. *See* Remarks of Robert Pozen, President and Chief Executive Officer, Fidelity Management & Research, at the Roundtable on the Role of Independent Investment Company Directors, Washington, DC (February 23, 1999) ("The second deficiency is one that the SEC has chosen to take a position on that I have always believed *doesn't make any sense.* The SEC's position is that independent directors are not allowed to see sales and promotional expenses. They are not allowed to consider them, unless there is a 12b–1 plan in place.") [Emphasis added].

[67] *See* Complaint, *Benzon* v. *Morgan Stanley,* No. 03–03–0159 (M.D. Tenn.).

[68] *See Benzon* v. *Morgan Stanley,* Morgan Stanley, 2004 WL 62747 (M.D. Tenn.).

[69] *See, e.g.,* Statement by Arthur Levitt at the Investment Company Institute (May 15, 1998) ("I want you to look beyond your prospectuses when you think about how you communicate with investors. I do, and I worry that the fund industry is building unrealistic expectations through performance hype. I read the ads. I see nothing but performance, performance, performance. Why not outline clearly the impact of expenses or the nature of risks?").

[70] Amendments to Investment Company Advertising Rules, Investment Company Rel. No. 26195 (September 29, 2003).

[71] DALBAR, Quantitative Analysis of Investor Behavior at 2 (2003).

[72] Notably, the Commission requires that the prospectus include a bar chart that shows a fund's return for each of the preceding 10 years. If such a disclosure is nec-

essary to make the prospectus not misleading, it is unclear why the same reasoning is not applicable in the context of a fund advertisement.

[73] Proposed Amendments to Investment Company Advertising Rules, Investment Company Rel. No. 25575, Part II.C (May 17, 2002).

[74] Amendments to Investment Company Advertising Rules, *supra* note 60.

[75] *See* Disclosure of Mutual Fund Expense Ratios in Performance Advertising, National Association of Securities Dealers (January 23, 2004).

[76] Letter from Paul F. Roye, Director, SEC Division of Investment Management, to Craig Tyle, General Counsel, Investment Company Institute (October 17, 2003).

[77] *See supra* note 64.

[78] Prohibition on the Use of Brokerage Commissions, *supra* note 31.

[79] Confirmation Requirements and Point of Sale Disclosure Requirements for Transactions in Certain Mutual Funds and Other Securities, and Other Confirmation Requirement Amendments, and Amendments to the Registration Form for Mutual Funds, Investment Company Act Rel. No. 26341 (January 29, 2004).

[80] Mandatory Redemption Fees for Redeemable Fund Securities, Investment Company Act Rel. No. 26375A (March 5, 2004).

[81] Amendments to Rules Governing Pricing of Mutual Fund Shares, Investment Company Act Rel. No. 26288 (December 11, 2003).

[82] *See* Ian McDonald, A Look at What Drives Money Managers' Pay, *Wall Street Journal Online* (March 16, 2004) (describing survey that found that "most portfolio managers say their firms' sales and profits are often greater drivers of their bonuses than the investment returns they earn for clients").

[83] Disclosure Regarding Portfolio Managers of Registered Management Investment Companies, Investment Company Act Rel. No. 26383 (March 11, 2004).

PREPARED STATEMENT OF WILLIAM D. LUTZ, Ph.D., J.D.

PROFESSOR OF ENGLISH, RUTGERS UNIVERSITY

MARCH 23, 2004

I would like to thank Chairman Richard Shelby for this opportunity to comment on the Security and Exchange Commission's proposed requirement that investors be provided with both cost and conflict of interest information before they invest in mutual fund shares and certain other investments.

I have served as a consultant in plain language to the Securities and Exchange Commission, and I have worked with a number of corporations and mutual fund companies to revise their documents into plain language. I have also written extensively on plain language and clear communication.

I believe the SEC's proposal is an important step in the right direction. As the SEC notes in its proposed rules, providing this information will help investors determine the full cost of an investment. Both point of sale and confirmation of sale disclosure will certainly go far in revealing to investors just what they are paying in fees for a particular investment. However, I think the proposal, as good as it is, does not go far enough, and what it does propose doesn't help investors as much as it could or should.

Right now investors face many problems in trying to figure out how much it will cost them to buy, hold, and sell shares in a mutual fund. First, they are overwhelmed with data, all kinds of data. Please note that I say "data" and not "information." "Data" consists of all the numbers, facts, and statements that fill the prospectus and the statement of additional information (SAI). Not only is there a flood of data, but it is located in two places. So assuming intrepid investors have carefully read the prospectus, and have even managed the Herculean task of reading the statement of additional information, just what have the investors learned? Who knows, because both documents offer "data" not "information."

Data is not information. Information is that which leads to understanding. In other words, data must be transformed into information. And who has the responsibility of performing that transformation? I would argue that the responsibility lies not with investors but with those who would sell investments such as mutual fund shares to investors. It is the responsibility of the seller to provide investors with information, not data.

Transforming data into information is the function of information design. Professionals in information design deal with designing everything from websites to the instrument panels in civilian and military airplanes. They also design documents that communicate information. Indeed, in 1984, one entire issue of *Information De-*

sign Journal, the international publication of professional information designers, was devoted to "The Design of Forms and Official Information." The editors of the journal said that this issue focused on the one question that concerned all citizens: How can complex organizations communicate with the public. Information designers have been working for over 20 years on the problems of designing documents that communicate complex information clearly. It would seem prudent, therefore, to use the skills of information designers when confronted with the challenge the SEC faces in designing their proposed set of disclosure forms.

Document design uses a variety of tools—from plain language to the best type face—to create a document that gives readers the information they need, and gives it to them simply, quickly, clearly, efficiently. Information design transforms data into information that readers can use. With information design, sellers can design disclosure documents that give investors not data but information.

To ensure that the forms they create do indeed communicate clearly and effectively, document designers evaluate their designs not theoretically but practically. They see how well the forms work when people use them. The procedure they use is called usability testing, and it is a well-established methodology that produces documents that meet the needs of those who use them. When joined with information design, usability testing produces documents that communicate, in every sense of that word. Data not only becomes information, but it also becomes information that people can use quickly, easily, and with a minimum of errors or misunderstanding.

Through usability testing, document designers discover what people want to know, and what they need to know in order to accomplish a specified task. Usability testing can help the SEC learn what information, if any, to leave out of the document because investors find it unnecessary, as well as learning what information investors want included. And I would like to stress that usability testing is a professional field, with proper procedures, standards, and protocols. (See, for example, Carol M. Barnum, *Usability Testing and Research,* Longman, 2002; Joseph Dumas and Janice Redish, *A Practical Guide to Usability Testing,* Ablex, 1993; Jeffrey Rubin, *Handbook of Usability Testing,* Wiley, 1994.) Investors should not have to root about the endless pages of dense, jargon filled prose of the statement of additional information. Nor should they have to piece together the information they need from the data scattered throughout the prospectus.

I am sure that usability testing would quickly reveal a fundamental problem with the SEC's proposed disclosure forms: All the forms present disclosure from the point of view of the seller, not the buyer. The proposed forms are designed to ensure that the broker conforms to the new rules about disclosure. They are not designed to communicate the information investors want and need to make informed decisions. Indeed, at this point no one, neither the SEC, I, nor anyone else, knows what investors want to know because as far as I know no one has asked them in a systematic, controlled way designed to elicit accurate, reliable information.

Right now investors have to assemble data from the prospectus and the statement of additional information. While the new forms proposed by the SEC will ideally present the most important cost data gathered from these two documents, we must remember that we are adding another document to the hierarchy of data for investors. These new forms should not replace the prospectus or the statement of additional information but should be designed to function as part of this hierarchy. The new forms should present in summary format the essential information about costs based on the statement of additional information and the prospectus, both of which should continue to be available to those investors who want to consult them. But the addition of these summary forms does not address the question of what information should be communicated to investors that is not now available.

To be sure, the SEC's call for comments on its proposed rules has elicited many comments, but these are from those people who just happened to learn about the proposed rules. These comments will certainly be helpful, but this procedure does not systematically engage investors in seeking to discover what they want to know. Document design and usability testing is a more effective, accurate, and reliable way to find out if these rules and the proposed disclosure forms will provide the information that investors need, what information investors want, what kind of forms will best communicate that information, and the best way to present the information so investors can use it.

Generally speaking, I think investors want to know what I, as an investor, want to know: What will it cost me to make this investment; What will it cost me while I own it; What will it cost me to sell it; and are there alternatives that are better and cheaper for me?

These are the money issues, and it should not be difficult to provide this information to investors. However, as *The Wall Street Journal* recently (March 17, 2004)

pointed out, mutual fund investors may be paying significant transaction costs while they hold their shares, and they probably do not know they are paying them. These costs are difficult to locate because, in the words of the *Journal,* they are "buried." The SEC has discussed these hidden costs in its concept release number 33–4389 (December 19, 2003) "Request for Comments on Measures to Improve Disclosure of Mutual fund Transaction Costs." In this release, the SEC identifies the transaction costs of commissions, spread, market impact, and opportunity. While estimates of the magnitude of these costs vary, it is very clear from the studies cited by the SEC that these transaction costs can add up to a significant expense, an expense which occurs yearly. These costs can substantially affect the rate of return for long term investors, as the *Journal* article dramatically illustrates in its hypothetical examples. Yet most of these costs are not revealed in any currently available documents for investors.

And this leads to another problem with the SEC's proposed disclosure forms. As presented, these forms imply that investors are being told of all the costs they are paying. Since the present proposal makes no provision for revealing these hidden costs in any disclosure form, investors are not informed of all the costs they are paying over the term of the investment. If these transaction costs are not included in the disclosure form, investors should be told that the expenses as listed on the form do not include transactions costs over the life of the investment, and these costs may significantly affect the return on their investment.

I am submitting with my statement a sample revision of the SEC's proposed disclosure form for a confirmation of a hypothetical purchase of a class A share (Attachment 1 to SEC Release No. 33–8358, January 29, 2004). This redesigned form is the result of a term effort that included me, Nancy Smith (who previously served as Director of the SEC Office of Investor Education and Assistance) and Dan Koh, of The Corporate Agenda, a design firm in New York. I must stress that this is not a final copy because we did not have time to conduct usability testing to refine the form. We addressed what we saw as the design deficiencies in the proposed SEC form, and we have tried to produce a document where investors can see in one place all the information that is currently available. And we have tried to design a form that communicates quickly, clearly, efficiently using both plain language and good document design.

In our form we tried to include all the data we thought important for investors, and we tried to turn it into information that the investor can use. Since we did not have the opportunity to conduct usability testing on the form, we do not know what information is not included in our form that investors would want included, nor do we know if investors would find unnecessary any of the information we have included. We did try to make the information clear, simple, and accessible. Among other techniques, we use serif typeface, a readable type size, lots of white space, plain language and no jargon, and we defined in context any terms we thought needed to be defined. We simply eliminated the full page of definitions included with the proposed form because it is been our experience that no one will read these definitions, let alone understand any of them. If a technical term is necessary in the disclosure form then it should be defined in the context in which it is used, but we found we could avoid technical language and still be clear and accurate. In short, we followed many of the principles of information design and plain language, principles that are listed and explained in the SEC's own publication, *A Plain English Handbook: How to Create Clear SEC Disclosure Documents,* which the SEC published in 1998 under the aegis of Nancy Smith and which I helped write. (You can download a copy of the handbook at *www.sec.gov/pdf/handbook.pdf.*)

Let me repeat that I think the SEC's proposed disclosure rules are extremely important in improving disclosure to investors. But let me also repeat and emphasize that as proposed the disclosure forms simply aren't up to what should be the SEC's standards for clear and effective financial disclosure documents. I have suggested here what can and should be done to make these forms really disclose information in a way that investors can use. I have also included a sample to suggest ways in which the SEC can improve its proposed forms.

Finally, I would like to urge that given the importance of clear, effective communication in financial disclosure documents the SEC should incorporate document design and usability testing into its regular procedures for producing all such documents. Many Federal agencies have already made extensive use of usability testing and document design to produce forms and documents, among them the Food and Drug Administration, Federal Trade Commission, National Institutes of Health, Internal Revenue Service, Veterans Benefits Administration, Federal Aviation Administration, and the Department of Housing and Urban Development.

The SEC must do more than just give investors new and better information. It must give investors this information in a form and format that really communicates

and doesn't simply present numbers. Document design is just as important as any other consideration when creating a financial disclosure document. I believe the SEC has done and continues to do an excellent job in providing American investors with access to more financial data than investors in just about any country in the world. Now, the SEC needs to take the next step to ensure that this data is transformed into information that investors can use. We must always remember that disclosure is not disclosure if it doesn't communicate.

Confirmation of Your Transaction

Prepared by	Prepared for	
Acme Clearing, Inc.	**William Lutz** **104 North Second Street #103** **Philadelphia, PA** Account number **1234-4556** Date of transaction **Jan 01, 2004**	Check this confirmation carefully. It covers your purchase price, fees, and whether your broker or brokerage firm received extra payments to sell you this security.

Details of your transaction

Amount you paid to buy **$ 8,000.00**	Number of shares bought **422.610**	Type of security **Mutual Fund**
Amount you invested in fund **$ 7,678.82**	Amount invested per share (Net Asset Value or NAV) **$18.17**	Security Issuer **BBB Equity**
Difference **$ 321.18**	Amount paid to buy per share **$18.93**	Symbol **FGBHJ**
	CUSIP number **000000**	Class of shares **A**
	Type of transaction **Buy**	

Total fees you pay to buy and own this fund at the end of...	1 year	3 years	5 years	10 years
What you will have paid in fees to buy and own this fund assuming the fund increases in value by 5% a year and the fees identified below remain the same throughout the years.	**$ 340.48**	**$ 381.64**	**$ 426.90**	**$ 560.76**
The fee as a percentage of your investment	**XX%**	**XX%**	**XX%**	**XX%**
Similar funds charge	**XX%** *to* **XX%**	**XX%** *to* **XX%**	**XX%** *to* **XX%**	**XX%** *to* **XX%**
Breakdown of fees at the end of...	1 year	3 years	5 years	10 years
Fees paid to broker/brokerage firm	**$ XX**	**$ XX**	**$ XX**	**$ XX**
Fees paid to the fund	**$ XX**	**$ XX**	**$ XX**	**$ XX**

On the next page you will find a breakdown of your total fees.

Facts you should know

Will you be able to transfer your shares in this fund to another brokerage account?	**No.** You can only hold these shares in this brokerage account. If you want to close this account, you will have to sell your shares.
Does your broker get paid more to sell you this fund?	**Yes.** Your broker gets more money to sell you this fund than similar funds because it is offered by a company affiliated with XX Brokerage.
Has the fund made extra payments to your broker or XX Brokerage to sell you this fund, payments called revenue sharing?	**Yes.** The fund paid your broker and XX Brokerage and additional $X for selling you the fund. The fund will also make extra payments of $X to them for each year that you own your shares in the fund. The payment as a percentage of your investment: X% Similar funds pay: X% to X%

Breakdown of fees to buy and own your shares

What you pay in fees	Who gets the fees and why	Compare these fees to what other people pay for similar shares
To Buy The amount you paid to buy these shares (called a front-end sales load). This is a one time fee that will not recur.	**$300.00** goes to your broker and the brokerage firm for advising you to buy it. **$21.18** goes to the fund for X.	**The fee as a percentage** of your investment: **4.18%** Similar funds cost: **1.45% to 4.56%**
To Own Here's what you are likely to pay to your broker, the brokerage firm, or the fund to own these shares. The fund will automatically deduct these fees from your shares, so you will not receive a separate bill. You will pay these fees for as long as you own these shares.	**Brokerage commissions** **$15.36** The fund pays XX Brokerage commissions for executing trades placed by the fund managers.	**The fee as a percentage** of your investment: **X%** Similar funds cost: **X% to X%**
	Management fees **$X** goes to the fund's investment adviser who manages the fund and selects its portfolio of securities.	**The fee as a percentage** of your investment: **X%** Similar funds cost: **X% to X%**
	Distribution and/or service (12b-1) fees **$19.20** goes to your broker or brokerage firm to compensate them for selling the fund to you and keeping account records of your fund investment.	**The fee as a percentage** of your investment: **X%** Similar funds cost: **X% to X%**
	Other expenses **$XX** goes to X for X.	**The fee as a percentage** of your investment: **X%** Similar funds cost: **X% to X%**

Save on large purchases - did you get the discount you deserve?

If you or your family members buy a large number of mutual fund shares, you may be entitled to a reduction in your purchase price. If you buy shares that require you to pay up front for your purchase (a front-end sales load) make sure you discuss with your broker if and when you are entitled to a discount. The fund's prospectus and its Web site also have information on how discounts work.

The records we have on your holdings, and any family holdings we know of, show that you should pay a sales load of 4.17%.

You were charged a sales load of 4.18% because rounding to the nearest penny caused the percentage to increase.

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PREPARED STATEMENT OF ROBERT C. POZEN

CHAIRMAN, MFS INVESTMENT MANAGEMENT

VISITING PROFESSOR, HARVARD LAW SCHOOL

MARCH 23, 2004

Thank you, Chairman Shelby, Ranking Member Sarbanes, and other Members of the Committee for this opportunity to present my views on appropriate reforms for the mutual fund industry.

My name is Robert C. Pozen and I am from Boston, Massachusetts. I am currently Chairman of MFS Investment Management, which manages approximately $140 billion for approximately 370 accounts including over 100 mutual funds serving approximately six million investors. I am also a Visiting Professor at Harvard Law School and author of the textbook *The Mutual Fund Business* (2 ed. Houghton Mifflin 2001).

I commend the Committee for engaging in a deliberative and broad-ranging review of the operations and regulation of the mutual fund industry. While I welcome questions about any aspect of the fund industry, I will limit my testimony today to three areas where I believe that MFS is helping to set important new standards for the fund industry: (1) maximized shareholder value through fund brokerage; (2) individualized reporting of shareholder expenses; and (3) structural enhancements for fund governance. We are making changes in these three areas to benefit MFS shareholders and, if followed by the rest of the industry, to benefit all fund shareholders.

Reducing Reliance on Soft Dollars

The current system of paying for goods and services with “soft dollars,” taken out of brokerage commissions, is detrimental to mutual fund shareholders. The use of “soft-dollar” payments makes it virtually impossible for a fund manager to ascertain the true costs of executing trades because execution costs are bundled together with the costs of other goods and services such as research reports and Bloomberg terminals. If these costs were unbundled, then fund managers could pay cash out of their own pockets for independent research or market data, and could negotiate for lower execution prices for fund shareholders.

Currently, if a trader from a mutual fund executes fund trades through a full-service broker on Wall Street, the trader pays 5 cents a share for execution plus a broad range of goods or services from the executing broker or third parties: For example, securities research, market data, and brokerage allocations to promote fund sales. These goods and services are paid in “soft dollars”: That is, they are bundled into the 5-cents-per-share charge in a nontransparent manner. If MFS does not accept these ancillary goods or services through “soft dollars,” it will still be required to pay 5 cents per share by the full-service broker.

In other words, it is almost impossible to obtain a price discount from a full-service Wall Street firm for executing a large fund trade. However, that firm is willing to provide an in-kind discount in the form of soft dollars that can be used to purchase various goods or services. This is more than a technical pricing oddity. The key point is this: A price discount on the trade (for example, from 5 cents to 3 cents per share) would go directly to the mutual fund and its shareholders. In-kind services like market data services go directly to the fund management company and only indirectly to the mutual fund and its shareholders.

MFS has already eliminated the use of “soft dollars” to promote sales of mutual fund shares. Since January 1, 2004, MFS has been paying cash out of its own pocket to broker-dealers to promote fund sales. While the SEC has proposed a rule to this effect, MFS has switched from soft dollars to cash to promote fund sales regardless of whether and when the SEC adopts its rule.

More dramatically, earlier this month MFS decided to stop using soft dollars to pay for third-party research [1] and market data. Again MFS will pay cash out of its own pocket for these items. MFS estimates that this decision will cost the management company $10 to $15 million per year. Yet MFS has agreed not to raise its advisory fees for its funds over the next 5 years.

Why is MFS willing to take the lead on getting off the addiction to soft dollars and moving to the healthy environment of price discounts? The simple answer is: MFS puts the fund shareholder first. We recognize the need to employ a full-service broker to execute a large block trade (for example, 500,000 shares in Genzyme); we need their skills and capital to actively work the trade and take up a portion of the

[1] We are not stopping the use of “soft dollars” for proprietary research and other services. Only recently has the SEC issued a concept release on accounting for all the elements of a bundled commission. SEC Release IC–26313 (December 19, 2003).

trade themselves if necessary. But we want to pay a price in the range of 3 cents per share for an agency-only trade, though we are willing to pay more for a trade requiring capital to be put at risk by the broker-dealer.

The broader answer is that MFS wants to lead the industry to lower and more transparent execution costs. To accomplish this objective, MFS will need support from other asset managers as well as the SEC. Section 28(e) of the Securities Exchange Act provides a safe harbor for asset managers using "soft dollars" for research and brokerage services. Initially, the SEC interpreted this safe harbor narrowly—allowing payment in "soft dollars" only if a good or service or product were not readily available for cash. Several years later, however, the SEC broadened the safe harbor to include any "legitimate" purpose for soft dollars (SEC Exchange Act Release 23170, April 23, 1986). The SEC should move back to its initial narrow interpretation of 28(e) to reduce the reliance on the use of "soft dollars."

Individualized Expense Reporting

MFS will issue an individualized quarterly statement, rather than a general listing of fund expenses in basis points, which will show each fund shareholder a reasonable estimate of his or her actual fund expenses in dollar terms. The MFS design for this individualized quarterly statement is cost effective as a result of one key assumption: That shareholders hold their funds for the whole prior quarter. This assumption is reasonable because over 90 percent of MFS shareholders fall into this category.

At present, the prospectus of every mutual fund contains an expense table listing the various categories of fund expenses in basis points. The table might say, for instance:

Fund Expenses	Basis Points
Advisory Fee	53
Transfer Agency Fee	10
Other Fees	2
12b–1 Fee	25
Total Expenses	90

In addition, the prospectus of every fund includes a hypothetical example of a $10,000 investment in the fund to show the dollar amount of actual fund expenses paid by such a fund shareholder during the relevant period. The hypothetical example for the mutual fund with the expenses described above, for instance, would show $90 in total fund expenses over the last year.

Nevertheless, some critics have argued that mutual fund investors need customized expense statements. By that, these critics mean the actual expenses paid by a shareholder in several funds based on his or her precise holding period as well as the fund dividends during that period. For example, we would have to compute the exact expenses of a shareholder who held Fund A from January 15 until March 31 without reinvesting fund dividends; another shareholder who held Fund B for the whole year and reinvested all fund dividends; and yet another shareholder who held Fund C from February 1 until June 15, as well as from August 22 until December 11 (during both periods, assuming no record date for fund dividends occurred).

This type of customized expense statement would, in my opinion, involve enormous computer programming costs. The program would have to track the holdings of every fund shareholder on a daily basis, take into account whether a fund dividend was reinvested or paid out to the shareholder, and apply monthly basis point charges to fund balances reflecting monthly appreciation or depreciation of fund assets. Of course, these large computer costs would ultimately be passed on to fund shareholders.

At MFS, we will provide every fund shareholder with an estimate of his or her actual expenses on their quarterly statements.[2] We can do this at an affordable cost by making one reasonable assumption—that the fund holdings of the shareholder at the end of the quarter were the same throughout the quarter. Although this is a simplifying assumption, it produces a good estimate of actual fund expenses since most shareholders do not switch funds during a quarter. Indeed, this assumption will often lead to a slightly higher estimate of individualized expenses than the ac-

[2] These individualized expenses will not include brokerage costs because they are capitalized in the cost of the portfolio security.

tual amount because some shareholders will buy the fund during the quarter and other shareholders will reinvest fund dividends during the quarter.

In addition, MFS will send its shareholders in every fund's semi-annual report the total amount of brokerage commissions paid by the fund during the relevant period as well as the fund's average commission rate per share (for example, 4.83 cents per share on average). But this information on brokerage commissions should be separated from the fund expense table because all the other items in the table are ordinary expenses expressed in basis points. By contrast, brokerage commissions are a capital expense added to the tax basis of the securities held by the fund, and brokerage commissions are expressed in cents per share.

Enhanced Governance Structure

The mutual fund industry has a unique governance structure: The fund is a separate entity from its external manager. The independent directors of the fund must annually approve the terms and conditions of the fund's contract with its external manager. Of course, the independent directors usually reappoint the management company. In an industrial company, how often do the directors throw out the whole management team? But the independent directors of most mutual funds, in my experience, do represent fund shareholders by negotiating for contract terms and monitoring potential conflicts of interest.

At MFS, we believe we have the most advanced form of corporate governance in the industry. To begin with, over 75 percent of the board is comprised of independent directors, who elect their own independent chairman. The chairman leads the executive sessions of independent directors, which occur before or after every board meeting. The independent chairman also helps set the board's agenda for each meeting. A lead independent director could definitely take charge of the executive sessions and a lead director could also help set the board's agenda. Thus, it does not matter which title is employed; the key is to ensure that a senior independent director plays these two functions.

In many boards, the independent directors have their own independent counsel, as the MFS boards do. But the independent directors of the MFS funds are going one step further by appointing their own compliance officer. This officer will monitor all compliance activities by MFS as well as supervise the fund's own activities, and will report regularly to the Compliance Committee of the Board (which itself is composed solely of independent directors).

On the management company side, MFS is the only company I know of that has a nonexecutive chairman reporting to the independent directors of the MFS funds. This is a new position designed to assure that the management company is fully accountable to the funds' independent directors.

Finally, MFS as a management company has established the new position of Executive Vice President for Regulatory Affairs, and filled the position with a distinguished industry veteran. In addition, MFS has hired a distinguished law firm partner as its new general counsel. Both will serve on the executive committee of MFS. The new Executive Vice President will be in charge of several regulatory functions—compliance, internal audit, and fund treasury. This high profile position within MFS is more than symbolic; it represents the great significance given by MFS to these regulatory functions. While these functions are performed in most fund management companies, it is rare to see the person in charge of these functions having the title of executive vice president and serving on the executive committee of the firm.

Conclusions

In summary, MFS is trying to establish standards of best practices in three important areas to fund shareholders: (1) reduced reliance on "soft dollars," (2) individualized expense reporting, and (3) enhanced governance structure. Other management firms are trying to take the lead in setting industry standards in other areas. At the same time, the SEC is in the process of proposing and adopting a myriad of rules on disclosure requirements and substantive prohibitions for the fund industry—which overlap to a degree with the efforts of the fund management firms.

Because the SEC and the management firms are making such serious efforts to develop higher behavioral norms for the mutual fund industry, it might be useful for Congress to monitor these efforts before finalizing a bill on mutual fund reforms. These are complex issues that may be better suited to an evolutionary process, led by an expert public agency with the flexibility to address the changing legal and factual environment.

Thank you again for this opportunity to testify on mutual fund reform. I would be pleased to answer any questions the Chairman or Committee Members might have.

PREPARED STATEMENT OF BARBARA ROPER

DIRECTOR, INVESTOR PROTECTION, CONSUMER FEDERATION OF AMERICA

MARCH 23, 2004

Good morning. I am Barbara Roper, Director of Investor Protection for the Consumer Federation of America. CFA is a nonprofit association of 300 consumer groups, which in turn represent more than 50 million Americans. It was established in 1968 to advance the consumer interest through research, education, and advocacy. Ensuring adequate protections for the growing number of Americans who rely on financial markets to save for retirement and other life goals is among our top legislative and regulatory priorities.

Introduction

I want to congratulate Chairman Shelby, Ranking Member Sarbanes, and the Members of this Committee for the thorough and careful attention you have given to a wide range of issues arising out of the recent mutual fund trading and sales abuse scandals. In the best tradition of the Congressional oversight process, your hearings have helped to inform the debate, guide the SEC regulatory response, and lay the groundwork for additional reforms.

Let me make clear at the outset, CFA believes the SEC has done a very good job since the trading scandals first broke of developing a strong and credible mutual fund reform agenda. While the SEC may have initially been caught unaware, it has since responded aggressively on all three fronts of Agency responsibility enforcement, oversight, and regulation. The settlements of enforcement actions announced by the SEC in recent months have included an appropriate combination of shareholder restitution, stiff penalties, and governance reforms. The Agency is reportedly at work on a number of positive steps designed to promote quicker identification of potential problems within the industry and to improve the quality of its oversight program. On the regulatory front, the Commission has proposed a host of new rules to end trading abuses, strengthen fund governance, and address a range of abuses in the sale of mutual funds.

It is in this area of the regulatory response that CFA has primarily focused its attention. Last November, CFA and Fund Democracy developed a "blueprint" for mutual fund reform, which we released together with Consumer Action, Consumers Union, and the U.S. Public Interest Research Group.[1] The document provided a brief review of the broad range of reforms we believed were needed to restore badly shaken investor confidence in the mutual fund industry. Our proposals fell into five basic categories: Reforms specifically designed to address trading abuses; reforms to improve regulatory oversight of mutual funds; reforms to enhance the independence and effectiveness of mutual fund boards of directors; reforms to improve mutual fund sales practices; and reforms to improve mutual fund fee disclosures. (A copy of the blueprint is included as an appendix to my testimony.)

The purpose of the blueprint was to provide a benchmark against which our organizations would measure legislative and regulatory proposals put forward in the wake of the trading and sales abuse scandals. In preparing for my testimony today, I have used that document as a starting point for assessing the adequacy of the SEC's regulatory response to date. My conclusions are necessarily preliminary, as the SEC is still in either the rule proposal or concept release stage on a number of key issues. We won't know for some time what the Commission's final actions will be. In some instances, we support the general thrust of an SEC proposal but have suggestions for significant amendments that may or may not be adopted. Despite those caveats, what is really quite remarkable is how many of the suggestions laid out in our blueprint have since been taken up by the SEC.

Despite that fact, we believe legislation is absolutely essential this year to fill certain significant gaps in the SEC's regulatory response. Several of these gaps result from the SEC's lack of authority to act. For example, legislation is needed to enhance the SEC's independent governance reforms by giving the Agency authority to impose its requirements directly, to strengthen the definition of independent directors, and to expand the fiduciary duty of fund directors. We also believe investors would benefit from a repeal of the soft-dollar safe harbor, which cannot be accomplished without legislation. In addition, we believe legislation is needed to give the SEC limited oversight authority over intermediaries that handle mutual fund transactions. This would allow the Agency to develop an effective alternative to the hard

[1] *A Pro-Investor Blueprint for Mutual Fund Reform,* prepared by Mercer Bullard, Founder and President of Fund Democracy and Barbara Roper, Director of Investor Protection for the Consumer Federation of America, November 25, 2003.

4 p.m. close that provides a strong degree of certainty that late trading will be prevented without the inequities associated with the hard 4 p.m. close.

When we look beyond the areas where the Agency is prevented from acting, the one area where we see major shortcomings is in the SEC's completely inadequate efforts to promote vigorous cost competition among mutual funds. This is a serious deficiency, since evidence strongly suggests market discipline is not currently serving as a reliable and effective check on excessive fees. Because bringing down costs even a modest amount would add billions each year to the retirement and other savings of mutual fund shareholders, we believe it is essential that Congress step in and adopt major improvements to mutual fund cost disclosure. The goal should be to enable and encourage investors to make better mutual fund purchase decisions and to enhance the ability of market forces to discipline costs.

These are the proposals we believe should be included in legislation this year. In addition, although the SEC has put forward a number of very useful proposals to reform mutual fund sales, we believe that the issue of abusive broker-dealer sales practices deserves much further scrutiny and a more comprehensive legislative and regulatory response. We recognize, however, that this as a task that cannot be accomplished in the time remaining in this legislative session. We, therefore, urge the Committee to make this a top priority for comprehensive review in the next Congress.

My testimony will briefly review the reforms we have advocated in each of the categories mentioned above, what actions the SEC has taken, where the SEC lacks authority to complete its reform agenda, and what additional actions Congress should take for the benefit of mutual fund investors. I will then lay out in greater detail what steps we believe are needed to promote effective cost competition in the mutual fund industry and to further reform broker-dealer sales practices.

Reforms to Address Trading Abuses

Our blueprint outlined several steps to ensure that abusive trading practices are ended, that perpetrators are punished, and that investors receive full and fair restitution for their losses.

Fair Value Pricing

Our Recommendation: As a starting point, our organizations advocated stricter enforcement of the existing requirement that funds price their shares accurately. Such an approach is key to reducing the opportunity for investors to trade rapidly in and out of a fund to take advantage of pricing discrepancies.

Commission Action: In December, the Commission issued a release clarifying its position that funds are required to calculate their net asset value based on the "fair value" of a portfolio security if the market quotes are either unavailable or unreliable. In addition, the Commission staff is reportedly currently gathering additional information about funds' fair value pricing practices to determine whether additional steps are needed. CFA strongly supports this approach. However, because fair value pricing introduces an element of subjectivity into the pricing of fund shares, it also creates an opportunity for abuse. We, therefore, believe it is essential that the SEC continue to carefully monitor funds' use of fair value pricing to ensure that a reform adopted to address one set of abuses doesn't itself become an avenue of abuse.

Congressional Oversight Needed: We urge this Committee to provide on-going oversight to ensure that mutual funds are not abusing fair value pricing or that this approach to pricing does not create unanticipated flaws in the pricing of mutual fund shares. Should it find problems with the use of fair value pricing, we urge the Committee to work with the SEC to identify steps that could be taken to eliminate those problems.

Mandatory Redemption Fees

Our Recommendation: Because pricing is not a perfect science, we also recommended requiring at least those funds that claim to restrict short-term trading to impose a small redemption fee on sales occurring within a short-time period after the purchase. We specified that the fee should be payable to the fund, so that shareholders and not management would receive the benefit. And we indicated that redemptions should be permitted without triggering a redemption fee in financial emergencies.

Commission Action: The Commission issued a proposed rule in March that would require all funds except those that disclose that they allow rapid trading to impose a mandatory, uniform 2 percent redemption fee on trades within 5 days of pur-

chase.[2] Although we have not yet had an opportunity to review this proposal in detail, it appears to meet the basic criteria that we laid out for helping to take the profits out of rapid trading. It contains provisions to allow partial, small, and emergency redemptions without triggering the fee, which should limit any potentially harmful effects on average retail investors. It also requires that fees be paid to the fund, not the fund managers. The rule also includes a requirement that intermediaries send funds, on at least a weekly basis, taxpayer identification numbers, and specific trading information for those shareholders who trade through omnibus accounts. This is an essential and welcome step to allow funds to identify those shareholders who engage in rapid trades and ensure that they pay appropriate redemption fees.

Prevent Late Trading

Our Recommendation: In addition to advocating tough sanctions for those who knowingly help their clients to evade late trading restrictions, we recommended that the Commission adopt an approach to ending late trading that relies on compliance systems to provide reliable tracking of fund trades. With that in mind, we suggested that the quality of compliance systems at funds and trade processing intermediaries needs to be upgraded to ensure detection of these and other abuses. We also noted that the system must allow an effective regulatory inspection of those procedures. Under our suggested approach, intermediaries who could not provide adequate assurances of the integrity of their order processing systems, including fool-proof time-stamping of trades, would be prohibited from submitting orders to the fund after 4 p.m.

Commission Action: The Commission has finalized a rule requiring that funds have policies and procedures in place that are designed to prevent late trading and requiring that these policies and procedures be administered by a chief compliance officer who reports to the fund board.[3] In addition, the Commission has proposed a rule requiring that all orders for the purchase or sale of mutual fund shares be received by the fund, its designated transfer agent, or a registered clearing agency before the time the fund is priced in order to receive that day's price.[4] Because of concerns expressed over inequities in this approach, the Commission is reportedly currently considering whether alternative approaches exist that would prove equally effective without posing the same drawbacks of a hard 4 p.m. close.

Congressional Oversight Needed: While we do not oppose the hard 4 p.m. close as a short-term solution to late trading abuses, we believe an alternative long-term solution must be found. With that in mind, we urge this Committee to monitor developments to ensure that the final, long-term approach adopted by the Commission meets basic standards of fairness to all investors.

Legislation Needed: In addition, the Commission has suggested that one reason it adopted the hard 4 p.m. close approach is that it lacks oversight authority over certain intermediaries who handle mutual fund transactions and therefore cannot assure their compliance with appropriate standards under an alternative system that relies on creating an end-to-end audit trail for mutual fund transactions. To the degree the Commission needs additional oversight authority to provide end-to-end tracking of mutual fund transactions, Congress should provide the Commission with that authority. The goal would be to provide the Commission with narrowly targeted oversight authority, for example to inspect systems to determine whether they are adequate to prevent late trading and other trading abuses. This would enable the SEC to identify those intermediaries that lack adequate systems to prevent trading abuses and deny them the privilege of forwarding transactions after the 4 p.m. close.

Reforms to Improve Regulatory Oversight of Mutual Funds

Because we believe the mutual fund scandals provided evidence of a structural breakdown of mutual fund oversight, our blueprint identified several steps necessary to strengthen regulatory oversight of the fund industry.

SEC Efforts to Enhance its Regulatory Operations

Our Recommendation: Acknowledging that the SEC had begun to take steps to improve its regulatory oversight, we urged Congress to support and expand on those efforts to ensure that the Agency gets at the root cause of its oversight failure in this and other areas.

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[2] File No. S7–11–04.
[3] File No. S7–03–03.
[4] File No. S7–27–03.

Commission Action: Responding to criticism that it should have detected trading abuses earlier, the Commission announced late last year that it was creating a new risk assessment office whose purpose is to identify emerging problems and better coordinate the Agency's response. In addition, in recent testimony before this Committee, Lori Richards, Director of the Office of Compliance Inspections and Examinations, outlined a number of steps being taken to improve the SEC's oversight of the mutual fund industry. These include creating a new surveillance program for mutual funds, improving examination procedures, by including more interviews and reviewing more e-mail for example, conducting more targeted mini-sweep examinations, and reviewing the largest and highest risk funds more frequently.

Congressional Action Needed: We believe these efforts both deserve Congressional support, in the form of adequate agency funding, and merit Congressional scrutiny, to ensure that they deliver the desired results, a more aggressive and effective oversight program for the mutual fund industry, and for the securities industry as a whole.

Independent Regulatory Board to Oversee Mutual Funds

Our Recommendation: We recommended that Congress consider creating an independent board, modeled after the Public Company Accounting Oversight Board, with examination and enforcement authority to supplement SEC oversight and enforcement efforts.

Commission Actions: SEC Chairman, William Donaldson, said in his November testimony before the House Financial Services Committee that the Commission was considering whether there were ways in which funds could "assume greater responsibilities for compliance with the Federal securities laws, including whether funds and advisers should periodically undergo an independent third-party compliance audit. These compliance audits could be a useful supplement to our own examination program and could ensure more frequent examination of funds and advisers." Ms. Richards indicated in her March testimony before this Committee that the size of mutual funds precluded a comprehensive audit of every area of fund operations. Given the poor record of private audits in uncovering wrongdoing, if the SEC needs a supplement to its own examination program, we believe a far better approach would be to create an independent board, subject to SEC oversight, to conduct such audits.

Legislation and Oversight Needed: As a first step, we believe Congress needs to assess the adequacy of SEC resources for oversight of mutual funds. If it is not possible to provide the Agency with adequate funding directly, Congress should determine whether an independent board would provide the best supplement to agency efforts. With this in mind, we support the requirement in legislation introduced by Senators Dodd and Corzine (S. 1971) to require a General Accounting Office study of the issue. We also urge this Committee, which has taken the lead in the past in improving SEC funding, to provide on-going oversight on this issue.

Settlements Without an Admission of Wrongdoing

Our Recommendation: Although the SEC settlements of trading abuse cases have included a number of proinvestor provisions, the Agency continues to rely almost exclusively in this and other areas on settlements without any admission of wrongdoing by the perpetrators. While we believe this is in most cases an appropriate approach for the agency to take, we also believe there are some instances when the Commission should not allow those guilty of egregious violations to get off without an admission of culpability. We therefore recommended that Congress look into this practice, not just with regard to the mutual fund scandals, but also with regard to the SEC's enforcement program more generally.

Congressional Action Needed: Either through its own oversight process or by commissioning a GAO report, we urge this Committee to examine the SEC policy of settling even cases involving egregious ethical and legal violations without an admission of wrongdoing.

Reforms to Enhance the Independence and Effectiveness of Mutual Fund Boards

The mutual fund scandals helped to shine new light on the failure of all too many mutual fund boards to provide effective oversight of fund managers on behalf of fund shareholders. To address this systemic breakdown in fund governance, we advocated a number of steps to improve the independence and effectiveness of fund boards.

Independence of Fund Boards

Our Recommendation: To clarify that fund boards are responsible for representing shareholders, not management, our organizations recommended that three-quarters

of fund boards be required to be independent and that funds be required to have an independent chairman. Such an approach should help to ensure that fund boards are firmly under the control of those individuals whose sole obligation is to shareholders. Given the primary role of the board in policing conflicts of interest and negotiating the management contract, we believe it is essential that funds be chaired and dominated by individuals whose loyalty is exclusively to shareholders.

Commission Action: The Commission proposed a rule that would require all funds that rely on one of the Commission's exemptive rules to have an independent chairman and three-quarters of board members who are independent.[5] The rule, portions of which face strong industry opposition, has not been finalized, so it is not clear whether this strong proposal will actually be adopted. The Commission also requested comment on a much weaker alternative approach that would require funds to have a lead independent director. This approach would continue to allow executives of the fund management firm to chair the board, putting them in the position, among other things, of negotiating with themselves when it comes time to negotiate the advisory contract.

Legislation Needed: Because the SEC lacks authority to strengthen the definition of independent director, individuals with close family and business ties to the fund manager could still serve in this capacity, undermining the intent of this reform. Congress should adopt legislation that, at a minimum, gives the SEC authority to strengthen the definition of independent director. The definition included in the bill introduced by Senators Fitzgerald, Collins, and Levin (S. 2059) provides both a good statutory definition and authorization for the SEC to further refine the definition as needed. The Dodd-Corzine bill (S. 1971) gives the SEC authority to add new categories of individuals who would be precluded from serving as independent directors because family or business ties to the fund manager. Either approach would provide much needed enhancements to the SEC's proposed independent governance reforms.

In addition, because the SEC lacks authority to impose its governance reforms directly, it is forced to rely on the indirect means of imposing them as a condition of relying on the Commission's exemptive rules. Past experience suggests that this approach may be most likely to fail just when it is needed most—when there is a bona fide confrontation between the independent directors and the fund manager. The risk is that, in the event of such a confrontation, the fund manager will simply cease relying in the exemptive rules, in which case the independence requirements will no longer apply. We therefore strongly urge Congress to amend the Investment Company Act to give the SEC authority to impose its fund governance requirements directly.

Congressional Oversight Needed: We also urge this Committee to monitor agency action on this issue to ensure that the final rule does not back away from the Commission's initial very strong reform proposal.

Election of Independent Directors

Our Recommendation: Fund directors rarely stand for election by shareholders, leaving shareholders with little ability to hold directors accountable for protecting their interests. We therefore recommended that independent directors be required to stand for election every 5 years.

Legislation Needed: The Committee should seriously consider adopting provisions from the Dodd-Corzine bill (S. 1971) which would require that all directors be approved by shareholders every 5 years and would establish a nominating committee composed entirely of independent members to nominate new board members.

Fiduciary Duty of Board Members

Our Recommendations: Current law imposes a fiduciary duty on a fund's manager and directors only with respect to fees received by the manager. We recommended that the fiduciary duty of fund directors be expanded to cover the totality of a fund's fees in relation to the services offered.

Commission Actions: As part of its rule on independent governance, the SEC would require fund boards to maintain records of documents used in the review of the fund manager's contract. It has proposed a separate rule that would require funds to disclose more detailed information regarding its approval of the advisory contract, including such factors as the actual cost of services provided and the degree to which economies of scale are being realized by shareholders.[6] We believe the Commission requirements are a good step toward making fund directors more aware of their responsibilities to keep fund costs reasonable and more accountable for how

[5] File No. S7–03–04.

[6] File No. S7–08–04.

they arrive at those decisions. However, we believe more can and should be done to increase board accountability on this central area of board responsibility.

Legislation Needed: The Fitzgerald-Collins-Levin bill (S. 2059) contains excellent provisions spelling out an expanded fiduciary duty for fund directors. We strongly support its adoption.

Reforms to Improve Mutual Fund Sales Practices

The mutual fund scandals helped to shine a light on a number of unsavory sales practices that stand in sharp contrast to the image brokers promote of themselves as objective, professional financial advisers. We recommended a number of steps to improve the quality of mutual fund sales practices and to give investors information they need to better protect themselves.

Presale Delivery of Mutual Fund Profile

Our Recommendation: When investors purchase mutual funds from brokers, they are not required to receive the fund prospectus until 3 days after the sale. The idea is that the broker's obligation to make suitable recommendations substitutes for full presale disclosure. Because this clearly provides inadequate protections to investors, we recommended that investors who purchase funds through a broker or other sales person be provided with at least a copy of the fund profile at the point when the broker makes his or her recommendation.

Commission Actions: The Commission has proposed a rule that would require point-of-sale disclosure of broker-dealer costs and conflicts, but it would not require comparable disclosure about the operating costs of the mutual fund or about other important fund characteristics, such as investment strategy and risk.[7]

Legislation Needed: We urge the Committee to adopt legislation that would require mutual fund investors to be provided with a copy of either the fund profile or the full prospectus at the time when a mutual fund purchase is recommended.

Disclosure of Broker Compensation

Our Recommendation: We recommended that mutual fund investors get the same disclosure on the transaction confirmation that is provided for virtually all other securities transactions showing how much the broker was paid in connection with the transaction. We also recommended that mutual fund investors get an up-front estimate of both broker compensation and the total cost of investing in the fund.

Commission Actions: The Commission has proposed a rule that would require point-of-sale disclosure of the dollar amount of any front-end or deferred sales load, if applicable, including the amount of the sales fee that is to be paid to the broker.[8] It would also require disclosure of the estimated first-year asset-based distribution fees or service fees to be received by the broker from the fund (12b–1 fees). In addition, the point-of-sale document would disclose whether the broker engages in certain practices that create potential conflicts of interest, including directed brokerage arrangements, revenue sharing payments, increased compensation for sale of proprietary products, and increased compensation for sale of back-end sales load products. The same rule would require disclosure on the confirmation statement of the actual amount paid in the sales load and how it compares with industry norms and the amounts paid to the broker by the fund and its affiliates.

The rule proposal offers significant progress in getting investors important information about costs and conflicts in advance of the sale. While we have not yet completed our review of the rule proposal, our initial review has led us to conclude that it needs significant amendments to improve the timing, format, and content of the proposed disclosures. Among other things, we believe it is essential that the proposed disclosures also include mutual fund operating costs, in addition to sales costs. Creating a document that purports to offer apparently comprehensive information on mutual fund costs but leaves out this key cost may make investors even less likely to consider operating costs when selecting a mutual fund than they already are. To the degree possible, information provided should be specific to the fund being recommended.

For example, instead of using boilerplate language referring investors to the prospectus for more information on breakpoints, it could identify the next available breakpoint opportunity. We also believe the disclosures should be reworded and reformatted to improve their readability for average, unsophisticated investors and should be tested for effectiveness on investors. Finally, we believe the information must be provided at the point of recommendation, rather than at the point of sale, so that the investor has an opportunity to consider the information in making their

[7] File No. S7–06–04.

[8] File No. S7–06–04.

purchase decision. Leaving these disclosures to the last minute when the investor is preparing to write a check or transfer funds for the purchase greatly diminishes the likelihood that they will be carefully read and incorporated into the purchase decision.

Congressional Oversight Needed: We urge this Committee to monitor development of this proposal to ensure that it fulfills its potential. We also believe investors would greatly benefit from a long-term comprehensive review of securities industry disclosure practices generally. The goal of such a review should be to determine, comprehensively, whether these disclosures are effective in giving investors the information they need about the professionals they hire and the products that they purchase, at a time when it is useful to them, and in a form they can understand. Ultimately, we believe investors would benefit from major reforms in the disclosure system. Obviously, that is not a goal that can be accomplished in the time remaining in this Congress. We therefore urge the Committee to make this a top legislative priority in the next Congress.

Directed Brokerage

Our Recommendation: Many fund managers compensate brokers for selling fund shares by directing their portfolio transactions to that broker, often paying commissions on those transactions that are higher than those available elsewhere. Because this drives up portfolio transaction costs and creates significant conflicts of interest for both fund managers and brokers, we recommended that this practice be banned.

Commission Actions: The Commission has proposed a rule that would prohibit funds from compensating brokers for distribution by allocating portfolio transactions to that broker.[9] It would require that funds have procedures in place to prevent allocation of portfolio transactions based on distribution considerations. We strongly support this rule.

12b–1 Fees

Our Recommendation: At the time we developed our blueprint, our organizations recommended only that disclosure of 12b–1 fees be reformed to eliminate the currently misleading impression that these are the only distribution payments being made by fund managers out of shareholder assets. Our thinking on this issue has since evolved, and we have subsequently recommended that all payments for distribution using shareholder assets be banned. We do not object to a system that allows periodic (annual, quarterly, or monthly) payments for distribution as an alternative to paying a front-end or deferred load, but we believe the current system creates unacceptable conflicts of interest. Furthermore, we believe the growing use of 12b–1 fees to compensate brokers is a direct result of funds' and brokers' desire to hide the distribution costs from investors who might otherwise prefer a genuine no-load fund.

Commission Actions: As part of its rule proposal to ban directed brokerage the Commission has solicited suggestions on how to reform 12b–1 fees.[10] Although it is too soon to say what approach the Commission will ultimately recommend, it appears to be leaning toward an approach that would require funds to deduct 12b–1 fees directly from shareholder accounts, rather than from fund assets. Under such an approach, the account-based fee would be subject to NASD caps on sales charges. This approach would make the charges more transparent, particularly if they are accompanied by good disclosures making clear that these are charges for the services provided by the broker rather than charges associated with operations of the fund. As an important added benefit, long-term shareholders wouldn't be forced to go on paying the fees after their own distribution costs had been paid, and existing shareholders would not be forced to bear the cost of distribution to other shareholders. While we have not yet had an opportunity to study the proposal in detail, we strongly approve of the Commission decision to study the issue and believe the approach they have outlined offers a number of significant benefits over the current system.

Congressional Oversight Needed: We encourage this Committee to conduct a comprehensive review of distribution practices in the securities industry to determine whether they create unacceptable conflicts of interest. Although the Commission has made a good start in examining mutual fund sales practices, we believe a more thorough, long-term review of this issue is warranted, as we will discuss in more detail below.

[9] File No. S7–09–04.

[10] File No. S7–09–04.

Reforms to Improve Mutual Fund Fee Disclosures

Regulators, financial advisers, and investor advocates all agree that minimizing costs is one of the most effective steps investors can take to improve the long-term performance of their investments. Unfortunately, most also agree that investors do not currently give adequate consideration to costs in selecting mutual funds and other investment products. This is a particularly troubling situation with regard to mutual funds, given the central role they play in the long-term savings of average, middle-class Americans. Our blueprint contained several recommendations to improve mutual fund fee disclosures to make them much more complete and to make it more likely that investors will incorporate that information into their investment decisions.

Portfolio Transaction Costs

Our Recommendation: Investors in mutual funds receive information on fund expenses that purports to provide an accurate assessment of the costs of operating that fund. In reality, however, the fund expense ratio omits what for many actively managed stock funds is the largest expense—the trading costs for portfolio transactions. Because this failure to include portfolio transactions costs results in fee disclosures that may dramatically understate actual costs, eliminates market discipline to keep these costs as low as possible, and creates a strong incentive for funds to pay for other operating costs through portfolio commissions, our organizations recommended that portfolio transaction costs be incorporated in the fund operating expense ratio.

Commission Actions: The Commission issued a concept release at the end of last year seeking suggestions on whether and how disclosure of portfolio transaction costs could be improved.[11] The industry opposes incorporating transaction costs in the expense ratio, and the Commission has long resisted this approach. It is therefore not at all clear that this concept release will result in meaningful improvements to portfolio transaction cost disclosure.

Legislation Needed: Congress should require that all portfolio transaction costs be included in the expense ratio that can feasibly be included. The Fitzgerald-Collins-Levin bill (S. 2059) takes a reasonable approach to this issue, requiring that at least the commission and spread costs be incorporated in the expense ratio and requiring that the information be provided both as part of a total expense ratio and separately. Such an approach allows the market to decide which number is most useful to investors. We urge this Committee to include this provision in any legislation it adopts on mutual fund issues.

Soft Dollars

Our Recommendation: Failure to incorporate portfolio transaction costs in the expense ratio creates a strong incentive for funds to find a way to pay for other items, beyond trading services, through their portfolio transaction payments. This allows fund managers both to create the impression that the funds are cheaper than they actually are and to shift costs the manager would otherwise have to absorb onto the fund shareholders. For these reasons, we have advocated a ban on use of soft dollars for all purposes. Such a ban should include a requirement that Wall Street firms unbundle their commissions and charge funds separately for research and other services currently being paid for through trading commissions.

Commission Actions: The Commission is reportedly studying soft-dollar practices, but it lacks authority to ban soft dollars. It could, however, take steps to improve the current situation, by limiting use of soft dollars to genuine research and requiring full disclosure of soft-dollar payments, including total unbundling of commissions by full-service brokerage firms who conduct portfolio transactions for mutual funds. Absent Congressional action, this is the approach we believe the Commission should take.

Legislation Needed: Because we believe a soft-dollar ban is the cleanest solution that offers the greatest benefits to investors, however, we urge this Committee to repeal Section 28(e) of the Investment Company Act.

Comparative Fee Disclosures

Our Recommendation: If the goal is to get investors to make more cost-conscious mutual fund purchase decisions, they need to receive cost information presale and in a format that is likely to help them understand the differences in mutual fund costs. To accomplish that goal, we recommended requiring that fee tables show both the average fees charged by a peer group of funds and the average fees for index funds that invest in the same types of securities. Ideally, the table should show the

[11] File No. S7–12–03.

dollar amount impact of those costs over 1-, 5-, and 10-year periods, assuming a uniform rate of return. Such an approach would help investors to better understand the significant differences in fund costs and the major impact that paying higher costs can have on long-term returns.

Commission Actions: The Commission adopted a rule requiring mutual funds to disclose their costs in dollar amounts in annual and semi-annual shareholder reports.[12] While requiring the information to be reported in dollar amounts, and in a form that allows comparison among funds, is a step forward, putting the information in the shareholder reports greatly minimizes its benefits. Because few investors read these reports in advance of a fund purchase, the new disclosures will do little if anything to change investor behavior or introduce meaningful cost competition to the mutual fund industry.

Legislation Needed: In order to promote cost-conscious purchase decisions by mutual fund investors, the Committee should adopt legislation that requires presale disclosure of fund costs and presents those costs in comparative terms, as described above. These changes could be incorporated into the fund profile document, as well as the prospectus, in keeping with our earlier recommendation that investors be provided with one or the other of these documents at the time a fund purchase is recommended.

Actual Dollar Cost Disclosure

Our Recommendation: As another way to get investors to focus more on costs, we recommended requiring funds to present individualized information on actual dollar amount costs on the shareholder account statement. Putting this information on the account statement would greatly increase the likelihood that it would get read. In addition, putting the information in close proximity to information on fund returns would help investors to understand how high costs can eat into fund returns. While not as desirable as presale disclosure, since it would come too late to influence the purchase decision, this approach could at least make investors more cost-conscious when it comes to future mutual fund purchases.

Commission Action: The Commission has opposed requiring individualized cost disclosure on account statements and adopted its far weaker shareholder report disclosure requirement instead.

Legislation Needed: The Committee should adopt legislation requiring mutual funds to provide dollar amount cost information on account statements in close proximity to information on fund returns.

Why High Mutual Fund Costs Persist

Three forces are supposed to work together to discipline mutual fund costs. Mutual fund boards of directors are supposed to ensure that fees are reasonable, and the SEC has authority to take action against fund boards and managers that charge excessive fees. But the main check on excess costs is supposed to be supplied by market discipline. Many within the industry argue that these forces, and market discipline in particular, are working effectively to keep costs reasonable. There is compelling evidence, however, that this is not the case.

To approach this issue from the simplest, most straightforward angle, CFA examined costs at S&P 500 index funds, using a list of such funds complied for us and Fund Democracy in July of last year by Morningstar. We chose this type of fund because no one can credibly argue that higher costs bring added benefits to shareholders in these passive investments, which seek only to match the returns of the underlying index. Yet, when we examined the data last fall, we turned up 16 fund families that offer S&P 500 index funds with annual expenses of more than 1 percent. This compares with expenses of 0.18 percent and 0.19 percent respectively for the Vanguard and Fidelity funds.

Most of the funds on the list were B and C shares, for which a significant portion of the annual expenses came in the form of 12b–1 fees set at or near the maximum permissible level. The most expensive of these was the AAL Large Company Index II B fund, with an annual expense ratio at that time of 2.18 percent. However, two of the funds on the list, the AAL Large Company Index A and Mainstay Equity Index A, charged front loads of 5.75 percent and 3 percent respectively for their very high-cost funds.

While distribution costs were a significant factor contributing to the high costs of most of the funds, virtually all of the funds on the list had underlying management and administrative costs (with 12b–1 fees subtracted) that were two, three, and even four times as high as those of the Vanguard and Fidelity funds. While we recognize that not every fund company can match the rock-bottom prices charged by

[12] File No. S7–51–02.

Vanguard, when such large discrepancies exist for a passive investment like an S&P 500 index fund, we believe it is reasonable to conclude that the costs at the higher end of that scale are excessive. If funds that charge clearly excessive costs exist among S&P 500 index funds, there is every reason to believe they exist among all other types of funds as well. A separate search for very high cost funds confirmed this view, when it turned up a handful of funds with annual expenses at or around 10 percent.[13]

The question is why, given the several protections that exist, high fund costs persist. One reason is that the SEC has never used its authority to attack excessive fees. Some progress is apparently being made on that front, with the enforcement division reportedly looking into high costs for index funds. Another reason is that mutual fund boards have too often taken the approach of approving fees as reasonable, without regard to the underlying cost of services provided, as long as they are not too far out of line with industry norms. The recently proposed rules on independent governance and disclosure regarding approval of the advisory contract offer the prospect of progress on this front as well. Supplemented by legislation as outlined above, this approach could provide real progress toward getting boards to take seriously their obligation to keep costs reasonable.

Despite this progress, market discipline will continue to be the primary factor keeping costs reasonable. In a market in which investors are free to choose from among hundreds of fund companies offering thousands of funds using several different distribution and pricing models, one would expect to find vigorous price competition. In reality, however, only a relatively small portion of the mutual fund marketplace could currently be said to be truly cost competitive. That is the roughly 13 percent of mutual fund transactions that occur directly between the fund company and the retail investor and outside of any employer-sponsored retirement plan.[14] While performance-based advertising may distort this market somewhat, the prevalence of relatively low-cost funds in the direct-marketed segment of the industry strongly suggests that minimizing costs is viewed as critical to success for funds that rely on their ability to sell themselves to investors directly.

As we all know, a growing percentage of mutual fund transactions today occur through employer-sponsored retirement plans.[15] In these plans, investors generally have very limited options and therefore very little ability to consider costs in choosing among funds. These investors must instead rely on their employers to consider cost when selecting the plan. But plans often compete for employers' business by keeping administrative costs low, which they are able to do by shifting those costs onto employees in the form of higher 12b–1 fees. While the recent trading scandals may have made employers somewhat more sensitive to their fiduciary duties in selecting a plan, it is by no means certain that this is that case or, if it is, that this new sensitivity will extend to issues of cost.

That leaves the approximately 50 percent of mutual fund transactions that occur through broker-dealers and other salespeople outside a company-sponsored retirement plan.[16] Funds that rely on this market compete to be sold, not bought. While funds that compete to be bought can be expected to do so by offering a high-quality product and good service at a reasonable price, funds that compete to be sold do so by offering generous financial incentives to the selling firm and to the individual salesperson. They do this through a variety of means sales loads, 12b–1 fees, payments for shelf space, and directed brokerage that drive costs to investors up, not down. This sales-driven model offers mediocre, high-cost funds a means to compete for sales despite the fact that better alternatives for investors are widely available. As such, it allows funds to survive, and even thrive, that simply could not do so in a truly competitive market.

How to Encourage Vigorous Cost Competition in the Mutual Fund Marketplace

To turn this situation around, it will require both truly innovative and effective cost disclosure and a new approach to sales practices.

[13] The search was conducted by Fund Democracy President Mercer Bullard in response to a request from Senator Fitzgerald. The highest cost fund turned up in that search was the Frontier Equity Fund, which according to its registration statement, has annual expenses of 43.24 percent and a front load of 8 percent. Because the adviser waives certain fund expenses, however, the annual fee charged to investors is reduced to 42.26 percent.

[14] Investment Company Institute, *2003 Mutual Fund Fact Book,* 43rd Edition.

[15] Ibid.

[16] "Misdirected Brokerage," by Rich Blake, *Institutional Investor Magazine,* June 17, 2003.

Improved Cost Disclosure

We have described above some of the changes needed to improve cost disclosure. The goal is to ensure that these disclosures provide the information that investors need to accurately assess costs, at a time when it is useful to them in making their purchase decision, and in a format that catches their attention and conveys the information clearly and compellingly.

Content: At its most basic, the cost information provided must be accurate. That means it must incorporate as many of the operating costs of the fund as possible. Ideally, this means including all portfolio transaction costs in the annual expense ratio. As we explained in more detail in our joint CFA-Fund Democracy comment letter on the SEC's concept release, we believe this is an achievable goal. Many funds already get an analysis of their total transaction costs for their internal use. Setting standards for computing these costs and then requiring that they be included in a total expense ratio, while complex, should therefore not pose insurmountable challenges.

Should Congress and SEC decide for some reason against incorporating portfolio transaction costs in the expense ratio, it becomes even more important to ban soft dollars, something the SEC cannot do on its own. Soft-dollar payments are used to shift operating costs out of the sunlight of disclosed costs and into the undisclosed arena of portfolio transaction costs. If portfolio transaction costs remain undisclosed, then it is imperative that they be used only to cover trading costs and not to cover other products and services. Failure to adopt these reforms makes a mockery of the expense ratio as an accurate reflection of mutual fund operating costs.

In addition, if cost disclosure is to promote cost-conscious purchase decisions, the information must be presented in a context that helps investors to understand the long-term implication of paying higher costs. We believe the best way to accomplish this is by requiring comparative information to be included when costs are disclosed. One such approach would be to require the fee table to include an average cost figure for funds in the category and an average cost for index funds that invest in similar securities. To make the information even more compelling, the 1-, 5-, and 10-year dollar amount added costs or savings, relative to the category average and the index fund cost should be presented. Showing an investor that, performance being equal, they will pay an additional $900 over 5 years in fees because of a fund's above-average costs might cause them to carefully consider what they are getting in return for those high costs. Showing that they could save thousands over 10 years by investing in a low-cost index fund could provide an even greater incentive to take costs into account when purchasing a fund.

Timing: It is simple common sense to suggest that cost competition will only thrive if investors receive cost information in advance of the sale. Yet the current disclosure system does not require that this information be disclosed until several days after the sale has been completed. The SEC has taken an enormous step forward by suggesting that distribution-related costs should be provided presale, but it has not suggested providing similar presale disclosure of operating costs. This makes no sense from an agency that has emphasized the importance of allowing market competition to discipline costs. Once you have taken the step of requiring presale disclosure, there is every reason to use that opportunity to ensure that investors receive all the appropriate information that should inform their purchase decision. We believe the best approach would be to amend the fee table along the lines that we have suggested above and require that investors receive a copy of either the fund prospectus or fund profile including that fee table in advance of the sale.

It is not enough to provide the information at the actual point of sale, when the check is being written or the funds are being transferred. At that point, the purchase decision has already been made. Far better is to provide the information at the point of recommendation, so that the investor has a reasonable opportunity to include cost considerations (and other factors, such as investment strategies and risks) as they decide whether to accept the recommendation or seek out a better alternative.

Format: Almost as important as getting investors the right information at the right time is getting it to them in a format that catches their attention. The best disclosure in the world can be fatally undermined if it is presented in a way that encourages investors to ignore it. If the Commission can be convinced, or compelled by Congress, to develop more effective cost disclosures, they should consult experts such as my fellow panelist Professor Lutz on the best way to convey the appropriate information. They should also be required to test prototype disclosures with investors to determine whether they are effective.

A New Approach to Product Sales

While improved disclosure can help to alert investors to conflicts of interest and to make them more aware of the importance of costs, disclosure alone is unlikely to promote vigorous cost competition in the broker-sold market. A broader solution to this problem must take into account the fundamental reality of how investors relate to brokers and other financial professionals and, specifically, the degree to which they rely on them for advice.

Brokers are legally salespeople, without an adviser's obligation to place client interests ahead of their own. In fact, their exemption from the Investment Advisers Act is conditioned on their limiting themselves to giving advice that is "solely incidental" or "merely secondary" to product sales. However, this is not how they present themselves to clients. Instead, they adopt titles, such as financial adviser or investment consultant, that are designed to convey to their customers that advice is the primary service they have to offer. They spend millions on advertising campaigns that relentlessly send the same message.

Even sophisticated personal finance writers often fail to make this distinction between brokers, whose role is to effect transactions in securities, and investment advisers, whose role is to offer advice. If those who make their living covering personal finance issues make this mistake, it should not come as a big surprise that unsophisticated investors tend to approach their relationship with their broker with an attitude of trust. Lacking confidence in their own financial acumen, they seek out the advice of a financial professional, and they expect to rely without question on that professional's recommendations.

Improved disclosure of conflicts of interest, as the SEC has proposed, should help encourage investors to see their financial professionals in a more realistic light. We doubt, however, that even the best disclosures will be able to overcome multimillion-dollar advertising campaigns that send exactly the opposite message. Instead, we believe it is long past time to require brokers either to live up to the advisory image they project—and accept the attendant responsibility to make recommendations that are in their customers' best interests—or to cease misrepresenting themselves to customers and prospective customers as advisers. To the degree that the Commission has taken a position on this issue, however, it has been to propose to expand the loophole that allows brokers to portray themselves as advisers, earn fees they identify as fees for advice, and still rely on the "solely incidental" exclusion from the Advisers Act.[17]

Even where advisers have an obligation to put their clients' interests ahead of their own, the SEC has not, to our knowledge, ever enforced this obligation with respect to price or challenged advisers based on their recommendation of high-cost, inferior products. We believe it is high time for the Agency to start. However, given its history on this issue, we doubt the Commission will take this position without prodding from Congress. As a first step, Congress should conduct a thorough investigation of the role and operations of brokers and advisers as the basis for legislation to ensure that their conduct matches their representations about the services they offer.

The focus on mutual fund sales practices has raised some issues that should be included in such a review. One question it has raised for us is why distribution costs should be set by and paid through the mutual fund. When an investor buys shares in Microsoft, Microsoft does not determine what the broker is paid for that transaction. As a result, we have vigorous cost competition among brokers when it comes to trading costs for stocks. Yet, when an investor purchases shares in a mutual fund, the mutual fund's underwriter sets the level of the broker's compensation, either through loads or asset-based distribution fees. This results in the kind of competition to be sold that we described above, a competition that drives costs up and allows mediocre, high-cost funds to survive that could not do so absent their ability to buy distribution. If funds got out of the business of competing to be sold, and brokers' compensation came directly from the investor and did not depend on which fund they sold, then brokers might begin to compete on the basis of the quality of their recommendations, and broker-sold funds might have to compete by offering a quality product and good service at a reasonable price, just as direct-marketed funds must do.

Obviously, this is not an approach that can be adopted without more thorough study of all of its implications. We believe, however, that similarly dramatic changes

[17] SEC Proposed Rule, "Certain Broker-Dealers Deemed Not To Be Investment Advisers," File No. S7–25–99. The rule was proposed in 1999, at which time the Commission adopted a "no action" position that assured brokers that they would not be subject to enforcement actions based on a violation of the rule pending adoption of a final rule. No final rule has been adopted, and the no action position is apparently still in place.

in the sales practices of brokers and other financial professionals will be necessary to truly change the dynamics of this marketplace in ways that benefit investors. We urge this Committee to include these issues on its agenda, if not this Congress, which is quickly drawing to a close, then in the next Congress.

Conclusion

Mutual funds have long offered the best way for investors who have only modest amounts of money to invest to obtain broad diversification and professional management. The trading scandals have sullied the fund industry's reputation, but they have also opened up an opportunity to reexamine some industry practices that have too long gone unchallenged. The SEC has so far done an excellent job of addressing many of these issues, particularly fund governance, sales abuses, and improved regulatory oversight.

There are, nonetheless, significant gaps in its efforts. Some result from the SEC's lack of authority to act. Others result from the SEC's apparent lack of a vision for how the market could be transformed. The most serious gap in this regard is the Agency's total failure to adopt reforms that would introduce vigorous cost competition in the mutual fund marketplace. It is a failure that is responsible for allowing billions of dollars to be transferred each year from the retirement savings of working Americans into the pockets of highly profitable mutual fund companies and financial services firms.

Because of the SEC's aggressive response to the mutual fund scandals, there is not a pressing need for sweeping legislation to address the abuses that have been uncovered. Legislation is clearly needed, however, to fill specific gaps in the SEC's regulatory agenda. Such a bill should do the following things:

- Strengthen the definition of independent director, authorize the SEC to impose its governance requirements directly (rather than as a condition of relying on exemptive rules), and clarify and expand the fiduciary duty of fund directors.
- Give the SEC the oversight authority it needs over intermediaries who handle mutual fund transactions in order to enable the Agency to adopt an alternative late trading solution that does not rely on a hard 4 p.m. close.
- Ban soft dollars.
- Direct the SEC to adopt rules to require that portfolio transaction costs be included in the operating expense ratio, to amend the fee disclosure table to provide comparative operating cost information; to require that mutual fund investors receive a copy of either the prospectus or the fund profile at the time when a fund purchase is recommended; to require dollar amount cost disclosure on shareholder account statements; and to pretest those disclosures for effectiveness in conveying the key information to investors.

It is also imperative that Congress continue to ensure that the Agency has adequate funding to fulfill its responsibilities, as this Committee has taken the lead in doing in the past. As part of that effort, we would encourage you to include in legislation a provision requiring a GAO study of whether investors would also benefit from creation of an independent oversight board for mutual funds. Another area that deserves further study, in our view, is the SEC's reliance on settlements without an admission of wrongdoing.

Beyond the issues that can and should be addressed in legislation this year, we believe there is a compelling longer-term need to reexamine broker sales practices. The goal should be to eliminate the gaping divide that separates the professional, advisory image brokers promote to the public and the reality of their conflict-laden, sales-driven conduct. Forcing brokers to live up to the advisory standards they promote, and raising the bar for advisors as well, would go a long way toward improving the long-term financial well-being of American investors.

We congratulate you, Chairman Shelby, and Members of the Committee for the thorough and careful consideration you have given to a wide range of mutual fund issues. That attention has already helped to support and promote proinvestor reforms at the SEC. It has also helped to identify additional areas where legislation is needed. We look forward to working with you to create a more equitable and honest mutual fund marketplace.

APPENDIX A

Fund Democracy
The Mutual Fund Shareholder's Advocate

CFA Consumer Federation of America

U.S. Public Interest Research Group

Consumers Union
Publisher of Consumer Reports

Consumer @ction

A Pro-Investor Blueprint for Mutual Fund Reform

Prepared by
Mercer Bullard, Founder and President of Fund Democracy and
Barbara Roper, Director of Investor Protection for the Consumer Federation of America

Sweeping reforms are needed to restore badly shaken investor confidence in the mutual fund industry. These reforms must do more than address the specific abuses uncovered by the recent state and federal investigations, they must also recognize and address the systemic nature of recent compliance failures and other problems, the role of broker-dealers in assisting the abuses, and other problems, such as excessive and poorly disclosed fund fees, that also result from poor board and regulatory oversight. Only a comprehensive approach to reform will justify renewed investor confidence in the integrity of the mutual fund marketplace. With that in mind, Fund Democracy, Consumer Federation of America, Consumer Action, and U.S. Public Interest Research Group offer the following specific proposals that we believe must be included in the legislative and regulatory response to the current mutual fund crisis.

1. Adopt reforms designed to address specific abuses uncovered by the recent investigations.

While our organizations strongly encourage Congress and the Securities and Exchange Commission (SEC) to look beyond the recent scandal in adopting mutual fund reforms, it is certainly not our intention that the current scandal be ignored. Any legislative and/or regulatory reform package should take specific steps to ensure that abusive trading practices uncovered in recent investigations are ended, that the perpetrators are punished, and that investors receive full and fair restitution for their losses.

A. Require Funds To Impose Short-Term Redemption Fees

The most substantial losses resulting from the current scandal were caused by funds' selling their shares at inaccurate or stale prices and allowing certain investors to trade rapidly in and out of the fund to take advantage of those pricing discrepancies. Some academics who have studied the issue have estimated that this practice costs long-term fund shareholders billions of dollars each year. Funds are already required to price their shares accurately, and this requirement should be more strictly enforced. To the extent that pricing is not a perfect science, however, some funds still may use slightly inaccurate prices that sophisticated traders can identify and exploit.

These opportunities would be eliminated by the imposition of a small redemption fee on all sales of fund shares occurring within a short time period after the purchase. Our organizations therefore support requiring funds (or at least those that claim to restrict short-term trading) to impose redemption fees of two percent for fund sales within 30 days of purchase, and permitting funds to impose redemption fees of up to five percent for sales within five days of the purchase. Funds that adopt such fees could also adopt procedures to permit redemptions without payment of the redemption fee in the case of a genuine emergency. In all cases, the redemption fee would be payable to the fund, so that shareholders would receive the benefits.

B. Take Steps to Prevent Late Trading

While some mutual fund companies apparently conspired to allow late trading in their funds, others were the victims of brokerage firms and other trade processing intermediaries who assisted their clients in evading those restrictions. Steps must be taken to better prevent evasion of the late trading restrictions, including tough sanctions against those who knowingly violate or aid their clients to violate those restrictions. In addition, the quality of compliance systems at both the funds and the trade processing intermediaries must be upgraded to ensure detection of these and other abuses and to allow an effective regulatory inspection of those procedures. Intermediaries who cannot provide adequate assurances of the integrity of their order processing systems, including foolproof time-stamping of trades, should be prohibited from submitting orders to the fund after 4 p.m. While we are reluctant to rely on a system that depends at least to some extent on after-the-fact regulatory scrutiny for its effectiveness, we believe such an approach could be effective, particularly when combined with a redemption fee imposed on short-term trades, which would reduce, if not eliminate, the financial reward for late trading.

C. Require Full and Fair Restitution of Shareholder Losses

Regulators, federal and state prosecutors, and the fund firms themselves have provided assurances regarding restitution for losses to shareholders. That is reassuring. However, these promises have been short on specifics indicating how those losses will be measured and how the compensation will be provided.

Any restitution remedy must, at a minimum, satisfy the following criteria. It must be accompanied by a public statement detailing the basis for the restitution amount and an explanation of the methodologies used to calculate the amount. Furthermore, payments must be based on a methodology that takes into account not just the dollar amount of the relevant trades, but also the dilution caused by those trades (whether resulting from the execution of the trades at a stale price or from the processing of an order entered after the fund was priced); any administrative, trading, performance and other costs resulting from such trades; and the amount that money would have earned in the interim based on the fund's subsequent performance. Those who profited from abusive practices should be forced to disgorge those profits, including management fees received on accounts of traders who engaged in these practices, sales charges received on account of these traders' transactions, and interest or other compensation received on loans to these traders. High level executives who were aware of abusive practices but failed to take action should also pay their share of investor losses and should be required to forfeit any compensation they received in connection with those practices.

2. Improve Regulatory Oversight of Mutual Funds

The mutual fund scandal represents a structural breakdown in the regulatory oversight of mutual funds. Some have faulted the SEC's inspection program, which certainly appears to be in need of a major overhaul. However, allegations of abusive trading practices at mutual funds have been around for years. The SEC shouldn't have waited to uncover evidence of a problem in routine inspections, it should have gone looking for signs of trouble. This did not occur. Even when the problem had been exposed and the SEC received a tip of problems at a particular fund company, it was slow to act. These are signs of a regulatory oversight operation that is fundamentally broken.

The SEC has recently announced that it is creating a new risk assessment office whose purpose is to identify emerging problems and coordinate the agency's response. This is a good idea, but it is just a start. Congress needs to look further to determine whether additional reforms are needed to buttress the SEC's inspection and oversight program. We believe the following are among those that ought to be adopted.

A. Create an Independent Regulatory Organization to Oversee Mutual Funds

One obvious conclusion from the recent scandals is that mutual fund directors at implicated fund companies have failed to provide fundamental compliance oversight of their funds. While fund directors have failed their shareholders, the existing regulatory structures have also failed fund directors, by not providing them with consistent, effective guidance regarding their duties. We believe the best way to redress this short-coming is for Congress to create an Independent Regulatory Organization (IRO), patterned on the Public Company Accounting Oversight Board, with examination and enforcement authority over mutual fund boards and financed out of fund assets or management fees. The purpose of the board would be to supplement, rather than supplant, the SEC as the primary regulator of the mutual fund industry.

While the SEC would continue to oversee investment advisers directly, the new board would, among other things, establish uniform, minimum fiduciary standards for fund directors' oversight of their funds, including their evaluation of advisory contracts, fund compliance procedures, and the implementation of those procedures.

B. Support and Expand SEC Efforts to Enhance its Regulatory Operations

As the SEC conducts its own internal investigation and reorganization, Congress should provide effective oversight of that effort in order to assure that it gets to the root cause of the SEC's lax regulatory response on this and other issues. The goal should be to revitalize the agency's inspection and oversight program, as well as to provide better direction for the agency's regulatory and enforcement efforts. In return for assurances of a newly aggressive approach to its regulatory responsibilities, Congress should provide the SEC with the resources it needs to fulfill those responsibilities effectively.

C. Review SEC's Reliance on Settlements without an Admission of Wrong-doing

The SEC's recent settlement with Putnam included many beneficial provisions for shareholders, particularly in the area of enhancing the independence of the board of directors. However, by settling such an egregious case without an admission of wrong-doing, the SEC has sent the unfortunate signal that this is yet another scandal for which no one is personally to blame. In its response to the recent corporate scandals, this administration promised a tough enforcement program, with individuals forced to accept the consequences of their actions. Congress adopted tough new criminal penalties. So far, however, we have seen little evidence that much has changed in a culture that favors quick settlements. While not every case should be subject to a protracted legal action, the worst cases should be held up as examples. The Putnam case would seem to qualify for this treatment, with fund managers apparently having timed their own funds – picking the pockets of their own shareholders – and management having done nothing to make them give back the money once the practices were uncovered. Congress should look into this practice, not just with regard to the Putnam settlement, but with regard to the SEC's enforcement program generally.

3. Enhance the Independence and Effectiveness of Mutual Fund Boards of Directors

As we noted above, mutual fund boards of directors at fund companies implicated in the scandal have clearly failed to provide fundamental compliance oversight of their funds. The recent scandals are not the only such evidence. Further evidence can be found in the exorbitant and unjustifiable fees that some funds impose, with the approval of the board, or in the soft-dollar and directed brokerage practices engaged in by many fund companies. One problem is that, even where they are independent in theory, mutual fund boards tend to be dominated by the fund managers. Legislative and regulatory responses to recent scandals must include comprehensive reforms designed to make boards more independent and effective.

A. Strengthen the Independence of Independent Directors

The current definition of an independent director includes a host of persons who are not independent from the fund manager. For example, a former director or officer of the fund's manager can be an independent director, as can a current officer or director of a service provider to the fund. The definition of independent director should be substantially strengthened, and the SEC should be given the authority to adopt rules excluding specified categories of persons from serving as independent directors.

B. Require an Independent Chairman

Most fund boards have a chairman who works for the fund's manager. All things being equal, when it comes to weighing issues where there is a direct conflict between the interests of the fund manager and the interests of shareholders, an independent chairman should provide stronger leadership and exercise greater independence in thought and action than a chairman who is employed by the fund manager.

C. Require a Substantial Majority of Independent Directors

To further clarify that boards really are designed as shareholders' representatives, three-quarters of their members should be required to be independent. This would allow the board to retain enough board members from the fund management to benefit from their expertise without risking domination by those members.

D. Require Independent Directors to Stand for Election.

Most fund directors are appointed for life and rarely stand for re-election by shareholders. Even when independent directors retire or resign, new independent directors often are not elected, because fund mergers have provided enough replacements to continue without any shareholder action. Fund shareholders should have a say in who serves as an independent director, and should have the ability to remove those who fail to act in their interests. Requiring independent directors to stand for election every five years would give them that ability.

E. Establish a Fiduciary Duty with Respect to All Fees.

Current federal law imposes a fiduciary duty on a fund's manager and directors only with respect to fees received by the manager. This has enabled the public offering of funds, in the most extreme examples, with annual expense ratios in excess of 10 percent – a level of fees that exceeds the one-time maximum sales load permitted under NASD rules and is inconsistent with the protections that should apply to a publicly offered investment vehicle. Fund directors and managers should have a duty to ensure not only that the manager's fee is reasonable, but also that the totality of a fund's fees is reasonable in relation to the services offered.

4. Improve Mutual Fund Sales Practices

Not all of the abusive practices in the recent fund scandals can be laid at the feet of fund companies. Some – like the failure to provide appropriate commission discounts and the sale of the inappropriate class of fund shares – are attributable to abusive sales practices by broker-dealers. We congratulate the SEC for its recent settlement with Morgan Stanley regarding its inappropriate sales practices, but a more comprehensive response is needed. Clearly, it is no longer reasonable to assert that brokers' obligation to make suitable recommendations substitutes for full pre-sale disclosure to investors. The following are important steps that Congress should take to reform broker-dealer sales practices.

A. Require Delivery of Fund Profile Prior to the Sale

Because the broker's suitability obligation is supposed to substitute for full disclosure, the securities laws do not require that brokers provide any disclosure document to shareholders at or before the time that the investment decision is made outlining key characteristics of that investment, including costs, risks, or investment goals. Current law requires only that a prospectus be delivered with the transaction confirmation, which is typically mailed days after the investor has made his or her investment decision.

In the mutual fund arena, a document exists – the fund profile – which covers basic characteristics of the investment. Such a document could easily be provided in advance of the sale – in person, through email, or by fax – without unduly delaying the sale. Since brokers have repeatedly shown that they do not consistently operate in their clients' best interests, and since the SEC has failed to enforce the suitability obligation to provide meaningful protection for investors, the time has come to require pre-sale disclosure of key investment characteristics, at least in the sale of mutual funds. (The fund profile should be updated to reflect the disclosure reforms we are advocating below.)

B. Require Disclosure of Brokers' Compensation

For virtually all securities transactions other than purchases of mutual fund shares, investors receive a transaction confirmation that shows how much the broker was paid in connection with the transaction. Permitting brokers to hide their compensation on the sale of mutual funds has spawned a Byzantine and harmful array of selling arrangements, including revenue sharing (also known as payments for shelf space), directed brokerage, and non-cash compensation. Mutual fund shareholders should be entitled to receive the same information as other investors in securities in the form of full disclosure of their brokers' compensation on fund transaction confirmations. Such disclosure also should show how breakpoints applied to the transaction, as well as any special compensation received by brokers for selling particular funds.

C. Require Point of Sale Cost Estimate

When buying a house, purchasers are provided with an estimate of their total closing costs before making a final decision. As discussed immediately above, fund shareholders do not even receive a final statement of their actual costs, much less an up-front estimate of such costs. Brokers should be required to provide, at or before the time the investor places the order, an estimate of compensation to be received by the broker in connection with the transaction and the total costs of investing in the fund.

5. Improve Mutual Fund Fee Disclosures

In addition to making fund boards more accountable for setting reasonable fund fees, Congress should take a number of steps to enhance the quality of fee disclosures to more accurately reflect real costs to investors. This would help to introduce greater competitive pressure on fund fees and would help to end distortions that result when certain types of cost are included in the fund's expenses and others are not.

A. Include Portfolio Transaction Costs in the Mutual Fund Expense Ratio

The mutual fund expense ratio omits what can be a fund's single largest expense: its portfolio transaction costs. These costs include the commissions paid by funds on portfolio trades, costs associated with the market impact of those trades, and the spread (difference between the bid and ask price) paid in connection with each trade. These costs can exceed a fund's total expenses. Commissions, which are the easiest of these costs to be quantified, should immediately be incorporated in the expense ratio. Congress should direct the SEC to come up with a plan for including all other portfolio transaction costs in the expense ratio as well.

B. Reform 12b-1 fees

The current method for disclosing 12b-1 fees is misleading, because it suggests that 12b-1 fees are the only distribution costs incurred by shareholders. In fact, shareholders also pay for distribution through fees paid to the fund's manager and through the allocation of fund brokerage to brokers in return for sales of fund shares. The fund fee table should provide investors with functional disclosure of how their money is being spent, regardless of the particular rule authorizing the fee. Fee tables should, in pie chart or other easily understood graphical presentation, show how fees are spent on portfolio management, transfer agent, distribution, custody and other services. Congress also should consider banning 12b-1 fees and requiring that all distribution expenses be paid out of the management fee, with disclosure showing on which types of services fees were spent.

C. Require Fee Comparison Disclosures

Mutual fund fee tables do not show how fees charged compare to those charged by similar funds or index funds that invest in similar securities. Providing this information would make it much easier for investors to compare fees across funds. The fee table should be required to show the average fees charged by a peer group of funds and by an index fund that invests in the same types of securities. This would not only aid investors to make better informed choices, it would provide essential market discipline for fund costs.

D. Require Disclosure of the Actual Fund Costs

Current rules do not inform shareholders about the actual cost they pay for their investments. A proposal put forward by the SEC – to require funds to disclose, in shareholder reports, the actual fees paid on a $10,000 account – does little to remedy this short-coming. In fact, the Government Accounting Office found that this disclosure would be less likely to be read than if it were placed in shareholders' quarterly statements, and that it would have less of an impact than if it showed shareholders' individual costs. Congress should require that quarterly (or at least annual) statements show the actual dollar amount of the shareholder's expenses during the period covered by the statement.

E. Require Disclosure Comparing Different Fund Classes

Many funds offer a bewildering array of different share classes. In some cases, shareholders have been sold classes of shares that provided the greatest payoff for the broker but are least suitable for the shareholder. Fund prospectuses (and fund profiles) should be required to compare, in a graphic format, the costs of investing in different classes over a 15-year period.

6. Miscellaneous Additional Reforms

A. Require Disclosure of Amount and Structure of Portfolio Managers' Compensation and Fund Investments

In some cases, a portfolio manager's compensation or fund investments may not align his or her interests with the interests of fund shareholders. For example, a fund portfolio manager who also manages a hedge fund or other private accounts may have an incentive to favor those accounts over the mutual funds. The highest-paid executives of operating companies are required to disclose their compensation and their trades in company stock, yet there is no comparable requirement for mutual funds. Recent revelations have included investments by portfolio managers that are harmful to shareholders' interests. At a minimum, Congress should require that fund managers disclose the amount and structure of their compensation and their investments (including timely reports of purchases and sales) in the funds they manage. In addition, Congress should consider banning, or sharply restricting, such practices as dual

management of mutual funds and hedge funds when they pose significant risks to investors.

B. Ban Soft Dollars

Mutual fund managers are allowed to cause their funds to pay higher commissions to cover services that the manager would otherwise pay for out of its own pocket. These services are not required to be used to benefit the fund that paid for them, and the cost of these services is not disclosed. These soft dollar arrangements increase fund costs and create unnecessary conflicts of interest.

C. Prohibit Fund Managers from Allocating Brokerage in Return for Fund Sales

Many fund managers compensate brokers for selling fund shares with fund brokerage. Under these arrangements, the fund manager pays the broker through commissions received in connection with a fund's portfolio transactions. This practice increases funds' portfolio transaction costs while reducing the amount the fund manager might otherwise spend on distribution, thus creating a significant conflict of interest. Fund managers should be prohibited from considering sales of fund shares when selecting brokers to effect fund transactions and should be required to obtain best execution on their trades.

D. Apply the Rule on Misleading Fund Names to "U.S. Government" Funds

Funds are prohibited from using misleading names, yet the SEC has taken the position that a fund with "U.S. Government" in its name can invest 100 percent of its assets in Fannie Mae or Freddie Mac securities. These securities are not guaranteed by the U.S. Government, which is the guarantee investors think they are getting when they invest in government securities. Congress should prohibit funds from using names that imply that they invest in U.S. government securities unless at least 80 percent of the funds' assets are actually invested in securities that are backed by the full faith and credit of the U.S. government.

Conclusion

Investors have benefitted greatly over the years from the opportunity mutual funds offer even those of modest means to gain broad diversification and professional management. Many average, middle income investors have relied on mutual funds as the one place in the securities industry where their interests were likely to get fair consideration. Although the dollar amounts that individuals have lost as a result of recent scandals is likely to be quite small, the blow to investor confidence has been enormous. The above proposals are key elements in the comprehensive approach to reform that the current mutual fund crisis demands. It is imperative that Congress and the SEC act quickly and forcefully to restore badly damaged investor confidence.

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QUANTITATIVE ANALYSIS OF INVESTOR BEHAVIOR

2003

JULY 14, 2003

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Introduction

➢ Background

Performance is a critical factor in shaping investors' perception of the mutual fund industry. Mutual funds are marketed as long-term investment vehicles; 5 and 10-year performance figures are highlighted everywhere from sales kits to annual reports. Investors' expectations of their own returns are based on this long-term philosophy. However, actual investor behavior belies their expectations. The *2003 Quantitative Analysis of Investor Behavior Study* (QAIB) explores how mutual fund investors' behavior affects the returns that they actually earn.

QAIB examines real investor returns in equity and fixed income funds from January 1984 through December 2002. Whether the mutual fund industry is enjoying rapid expansion in times of economic boom or is being battered by the bears, the key finding uncovered in DALBAR's first study done in 1994 remains true: **Investment return is far more dependent on investment behavior than on fund performance. Mutual fund investors who held their investments were more successful than those who timed the markets.**

➢ Methodology

Investor behavior and performance are uncovered through an examination of:

- Real Investor Return –the rate of return investors earn, based on the length of time shareholders actually remain invested in a fund and the historic performance of the fund's appropriate index. Indices used in this study include:
  - Equity Index – comprised of the Standard and Poor's 500 Index and Small Company Stocks;
  - Fixed Income Index – comprised of long-term government bonds, long-term corporate bonds and intermediate government bonds.
- Monthly Cash Flows – the monthly increase/decrease of assets under management in equity and fixed income. Monthly cash flows include new sales, reinvested dividends, redemptions, exchanges in and exchanges out of the funds.
- Retention Rates – the average length of time shareholders remain invested in a fund, calculated through a comparison of net redemptions to the overall assets of the fund.
- Trade Volume – the total volume of sales, redemptions, exchanges in, and exchanges out of equity and fixed income funds.

DALBAR calculations and analysis are based on:

- Monthly returns from 1984 – 2002 of the above-mentioned indices provided by the *Stock, Bonds, Bills, And Inflation® 2003 Yearbook, © Ibbotson Associates, Inc.*
- Mutual fund sales, redemptions, exchanges, reinvested dividends and assets under management provided by the Investment Company Institute.

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Key Findings

✓ **Investors switch investments, earning equity fund returns lower than inflation.**

The average investor's return is significantly lower than market indices', due primarily to market timing. The average equity investor earned a paltry 2.57% annually; compared to inflation of 3.14% and the 12.22% the S & P 500 index earned annually for the last 19 years. The average fixed income investor earned 4.24% annually; compared to the long-term government bond index of 11.70%.

✓ **Fund cash flows chase market performance.**

Investors attempt to cash in on the rise of the market. When the S & P 500 rises, investors pour money into equity funds; and when the S & P drops, the money going into equity funds declines. The same pattern holds true with the fixed income investor.

✓ **Major political and world events have little effect on equity and fixed income funds' trade volume.**

The major events of the last 19 years, including presidential elections, terrorist attacks, war, and national and world unrest did not cause a major spike or drop in mutual fund trade volume.

✓ **Investors hold fixed income funds LONGER than equity funds.**

Investors remain invested in fixed income funds for 34.3 months on average, which is slightly higher than the 29.5 months investors hold on to equity funds.

✓ **When held for the long term, equity funds had best long-term gain.**

Despite the last three years of a down market, equity funds still had higher returns for investors investing for the long-term, averaging a 12.22% annual return for the past 19 years. Due to investor behavior, however, the average equity investor only earned just over half the return of the average fixed income investor.

Overview

FEAR AND GREED DOMINATE THE AVERAGE INVESTOR'S BEHAVIOR

Despite the current bear market, annualized returns for major market indices over the last 19 years are impressive, ranging from 9.24% to 12.22%. Yet the average mutual fund investor earned only a fraction of those market indices' returns, primarily because investors did not invest for the long-term.

As market returns rose, investors poured cash into funds in an attempt to capitalize on high returns. When the market swung low, investors scrambled to redeem their shares before they lost additional money. In fact, the average investor remained invested in equity or fixed income funds for less than three years, their decision to sell or buy motivated primarily by the swings in the market. The end result is investors buy high and sell low, and earn significantly less than the market indices, as the following chart indicates.

Investment return is far more dependent on investment behavior than on fund performance. Mutual fund investors who simply remained invested earned higher real investor returns than those who attempted to time the market.

CATEGORY	1984-2002	
	CUMULATIVE RETURN[1]	ANNUALIZED RETURN[2]
S & P 500 Index	793.34%	12.22%
Small Company Stock Index	538.94%	10.25%
Average Equity Fund Investor[3]	**62.11%**	**2.57%**
Long-term Government Bond Index	718.05%	11.70%
Long-term Corporate Bond Index	659.30%	11.26%
Intermediate-term Bond Index	436.40%	9.24%
Average Fixed Income Fund Investor[3]	**120.06%**	**4.24%**
Treasury Bills	175.89%	5.49%
Inflation	79.80%	3.14%

[1] *Calculated by DALBAR using data presented in Stocks, Bonds and Inflation® 2003 Yearbook, © Ibbotson & Associates, Inc. Based on copyrighted works by Ibbotson and Sinquefield. All rights reserved. Used with permission.*
[2] *Annualized rate of return assumes returns are compounded annually.*
[3] *The rate of return investors earn; based on the length of time shareholders actually remain invested in a fund and the historic performance of the fund's appropriate index.*

> **The average equity investor's real returns are lower than inflation.**

Average investor returns for both fixed income and equity funds were the lowest returns recorded since DALBAR began monitoring investor behavior in 1984. A combination of the recent bear market and constant entering and exiting funds, has made investing in mutual funds a dubious proposition for investors. As the following chart shows, equity investors did not keep pace with inflation.

ANNUALIZED RETURNS SINCE 1984[4]				
CATEGORY	**2002**	2001	1997	1992
S & P 500 Index	**12.22%**	14.51	17.18	15.51
Small Company Stock Index	**10.25%**	11.74	12.46	8.80
Average Equity Fund Investor	**2.57%**	**4.17**	**6.71**	**8.27**
Long-term Government Bond Index	**11.70%**	11.36	12.73	13.99
Long-term Corporate Bond Index	**11.26%**	10.98	12.34	14.12
Intermediate-term Bond Index	**9.24%**	9.04	9.62	11.46
Average Fixed Income Fund Investor	**4.24%**	**4.72**	**7.48**	**6.31**
Treasury Bills	**5.49%**	5.70	5.96	6.74
Inflation	**3.14%**	3.14	3.38	3.82

[4] A listing of annualized returns for the past decade is displayed in Appendix A.

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INVESTORS FAIL INVESTMENT 101

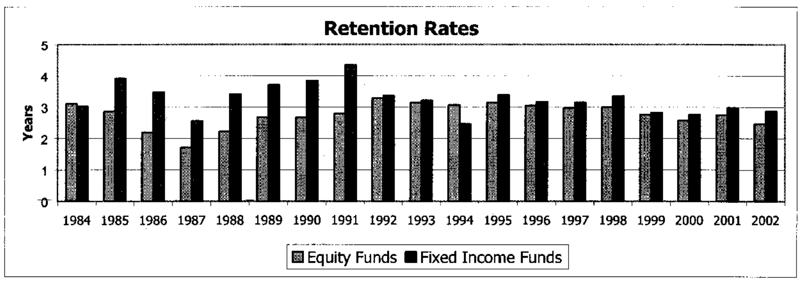
➢ **Investor retention[5] of funds is at its lowest level since 1988.**

As a result of a shrinking asset base, investor retention has dwindled in recent years.

- The average equity investor remains invested in a fund for about 2 ½ years, down from a high in 1992 of about 3 ¼ years.
- The average fixed income investor remains invested in a fund for about 3 years, down from a 1991 high of about 4 ¼ years.

➢ **Investors hold fixed income funds LONGER than equity funds.**

A comparison of the retention rates of equity and fixed income funds reveals that investors remain invested in fixed income funds longer than in equity funds. This is despite the mutual fund industry's attempt to educate the investor that equity funds should be considered long-term investment vehicles.



[5] Retention rate is defined as the average length of time shareholders remain invested in a fund, calculated through a comparison of net redemptions to the overall assets of the fund.

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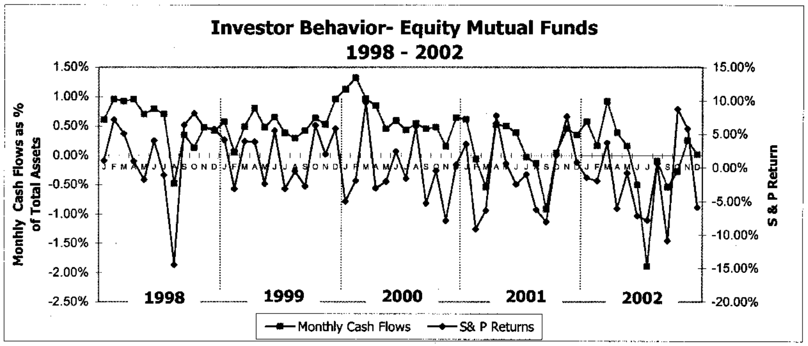
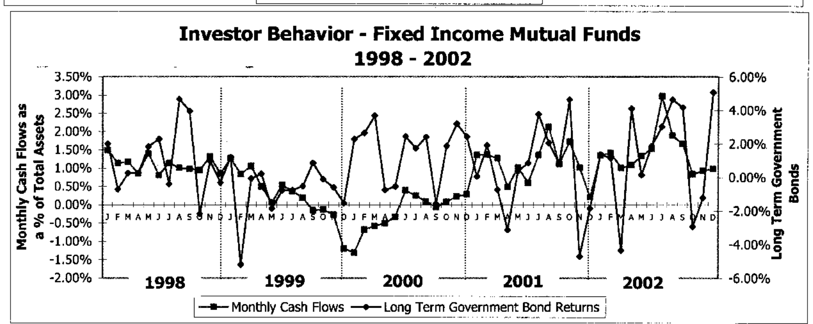
FUND CASH FLOWS CHASE MARKET PERFORMANCE

➢ **Investors lose their cool when returns drop**

The "buy high/sell low" behavior pattern of mutual fund investors is obvious when the net cash flows of mutual funds are compared to an appropriate market index. Mutual fund investors are chasing returns; with few exceptions, monthly cash flows decrease when markets show a negative return and increase when the market rises.

The following two charts show cash flows and market returns for both the equity and fixed income market.





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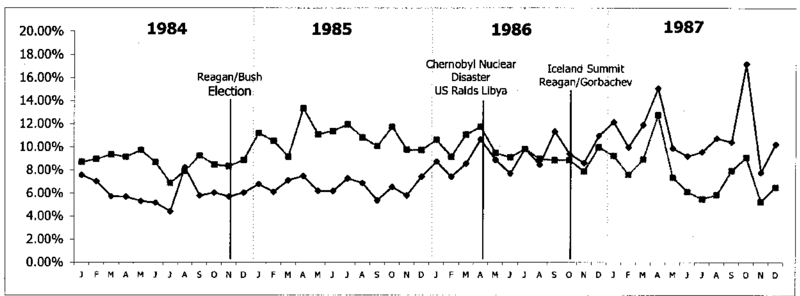
INVESTORS FOLLOW THE MARKET, NOT THE NEWSPAPERS

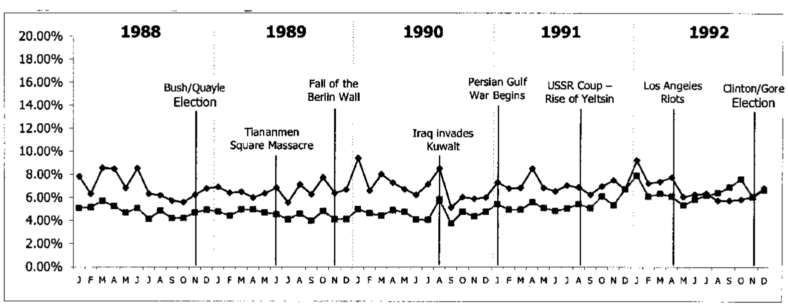
Major political and world events do not directly affect the volume of monthly trade activity in funds. An examination of major events over the last 19 years unveiled no discernable correlation between a major event and trade volume.

Trade Volume (as a % of Total Assets)

1984 - 2002

Fixed Income Funds
Equity Funds





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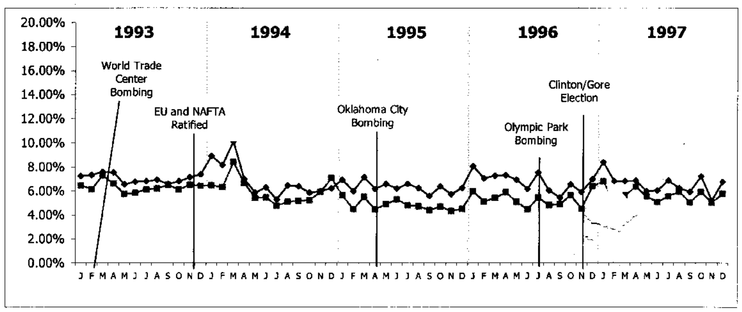

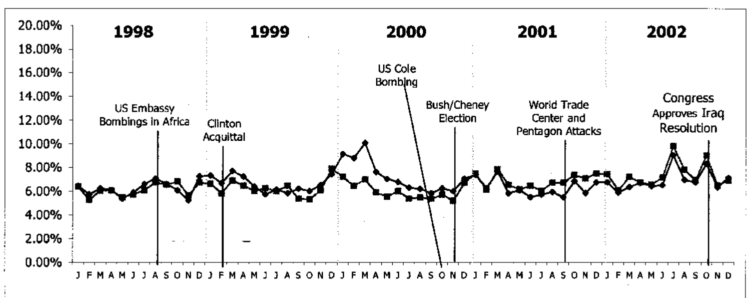

Appendix A – Annualized Returns

Annualized Returns

The following appendix displays average annual returns for market indices and the average investor. Returns are compounded annually.

Indices' annual returns assume an initial investment made in 1984.

Average investor return is the rate of return investors earn; based on the length of time shareholders actually remain invested in a fund and the historic performance of the fund's appropriate index.

ANNUALIZED RETURNS											
CATEGORY	**2002**	2001	2000	1999	1998	1997	1996	1995	1994	1993	1992
S & P 500 Index	**12.22%**	14.51%	16.29%	18.01%	17.90%	17.18%	16.01%	15.45%	13.63	14.94	15.51
Small Company Stock Index	**10.25%**	11.74%	11.12%	12.11%	11.02%	12.46%	11.71%	11.22%	9.32	9.96	8.80
Average Equity Fund Investor	**2.57%**	4.17%	5.32%	7.23%	7.24%	6.71%	6.13%	6.22%	4.80	6.33	8.27
Long-term Government Bond Index	**11.70%**	11.36%	11.83%	11.25%	12.76%	12.73%	12.50%	13.70%	12.82	14.41	13.99
Long-term Corporate Bond Index	**11.26%**	10.98%	11.00%	10.89%	12.23%	12.34%	12.35%	13.25%	12.07	14.02	14.12
Intermediate-term Bond Index	**9.24%**	9.04%	9.13%	8.91%	9.66%	9.62%	9.72%	10.38%	9.83	11.43	11.46
Average Fixed Income Fund Investor	**4.24%**	4.72%	6.08%	5.02%	6.33%	7.48%	7.29%	8.02%	5.87	6.32	6.31
Treasury Bills	**5.49%**	5.70%	5.82%	5.81%	5.88%	5.96%	6.02%	6.08%	6.12	6.91	6.74
Inflation	**3.14%**	3.14%	3.23%	3.23%	3.26%	3.38%	3.51%	3.51%	3.61	3.71	3.82

Appendix B – Investor Behavior

The following appendix displays investor behavior from 1984 – 2002 by comparing monthly cash flows in and out of equity and fixed income funds to their appropriate market index.

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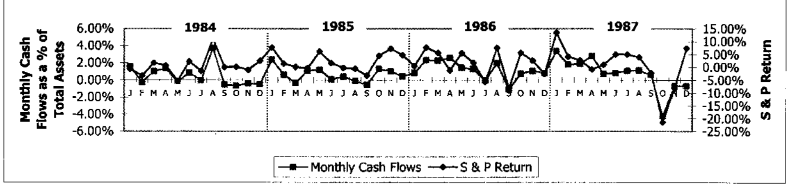
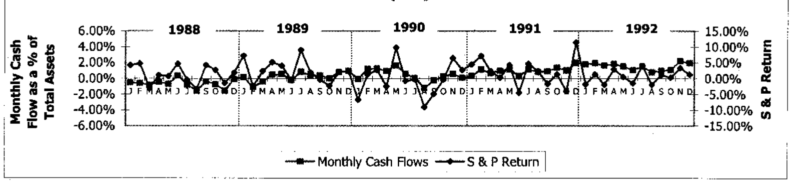
Equity Fund Overview

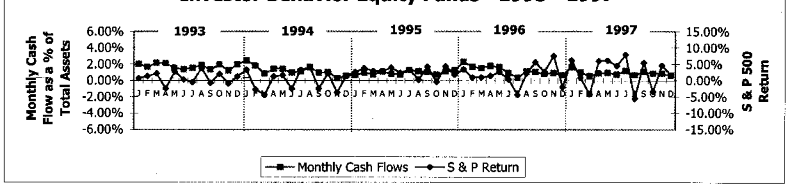
Investor Behavior - Equity Funds 1984 -1987



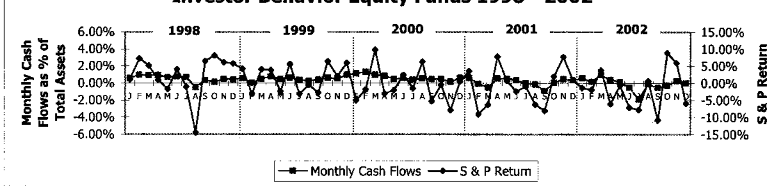
Investor Behavior - Equity Funds 1988 -1992



Investor Behavior Equity Funds - 1993 - 1997



Investor Behavior Equity Funds 1998 - 2002



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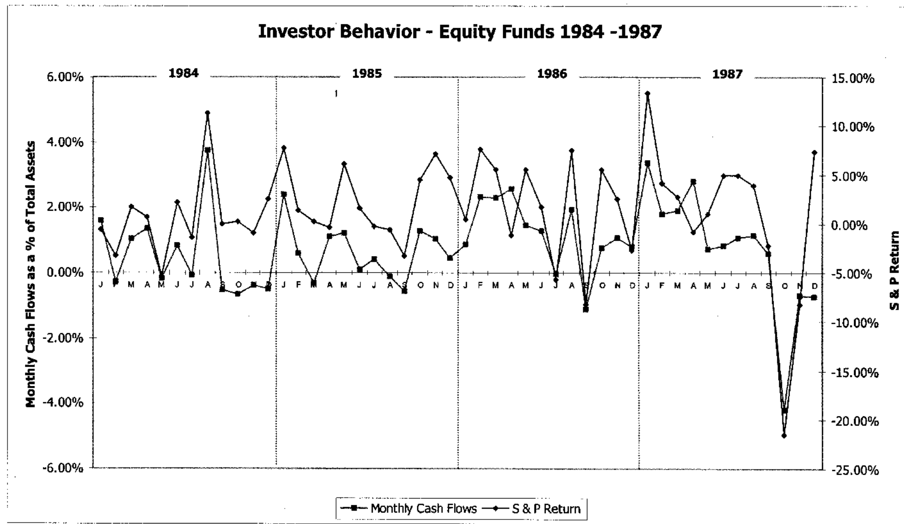

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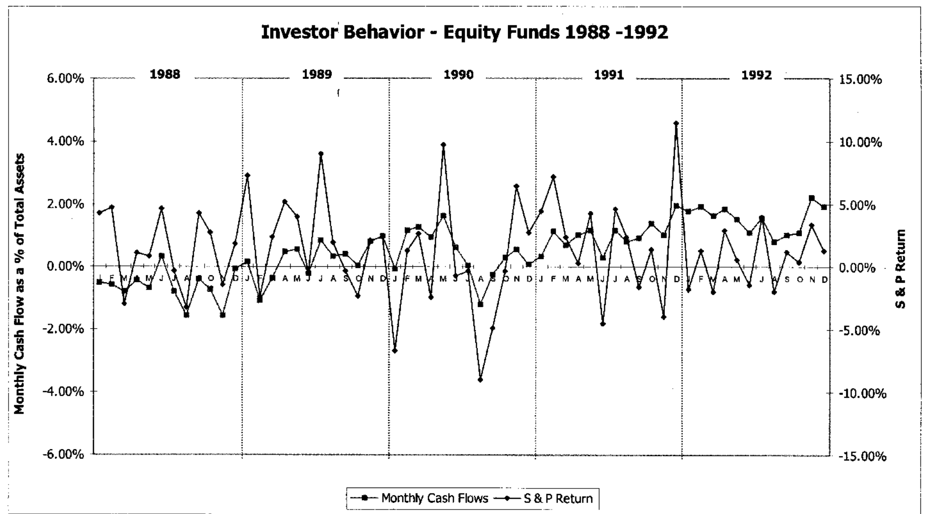
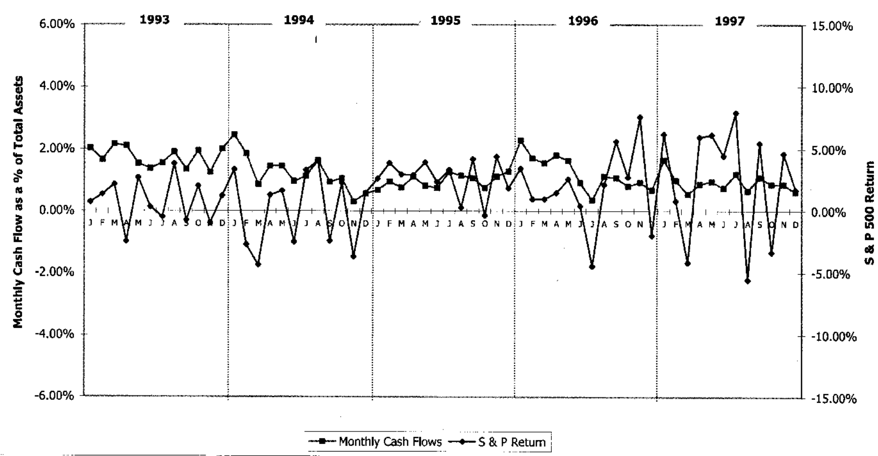


Investor Behavior Equity Funds - 1993 - 1997



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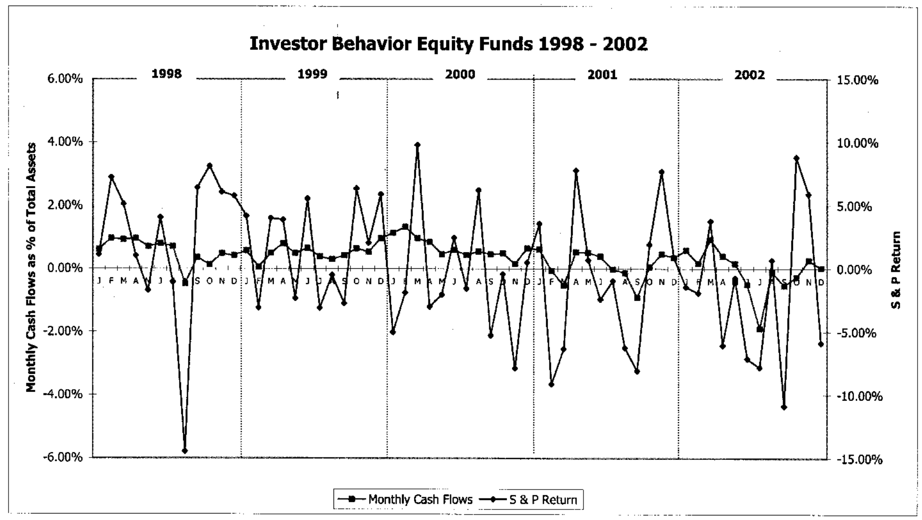

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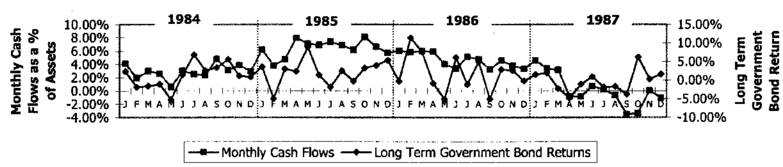
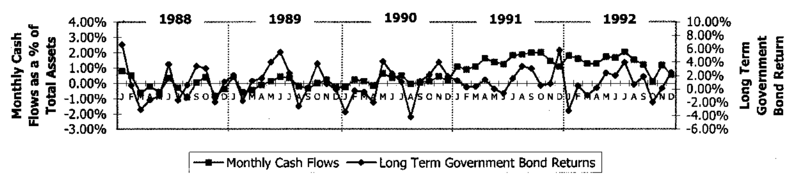
Fixed Income Fund Overview

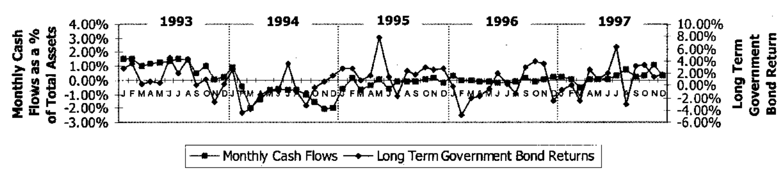
Investor Behavior Fixed Income Funds 1984 - 1987*



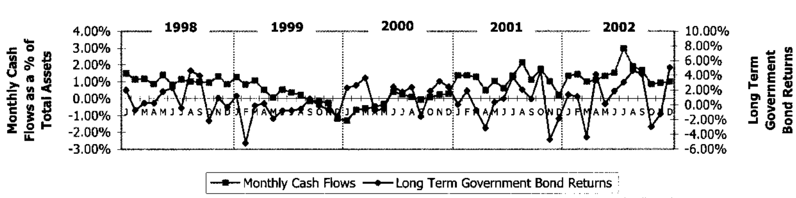
Investor Behavior Fixed Income Funds 1988 -1992



Investor Behavior Fixed Income Funds 1993 - 1997



Investor Behavior Fixed Income Funds 1998 - 2002



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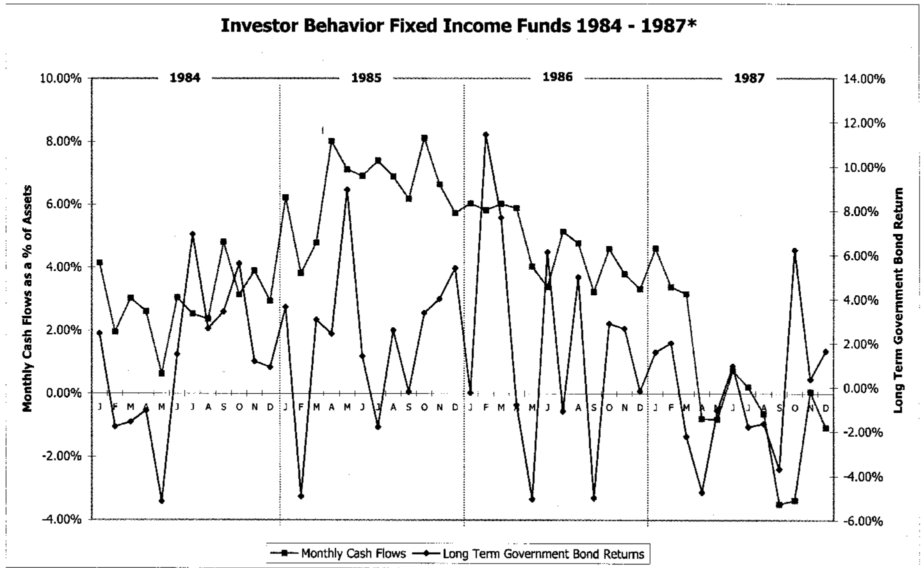
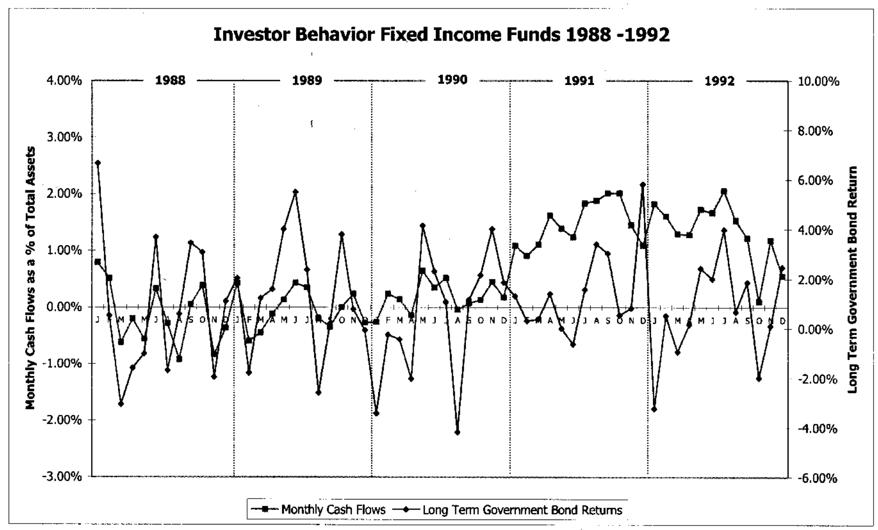
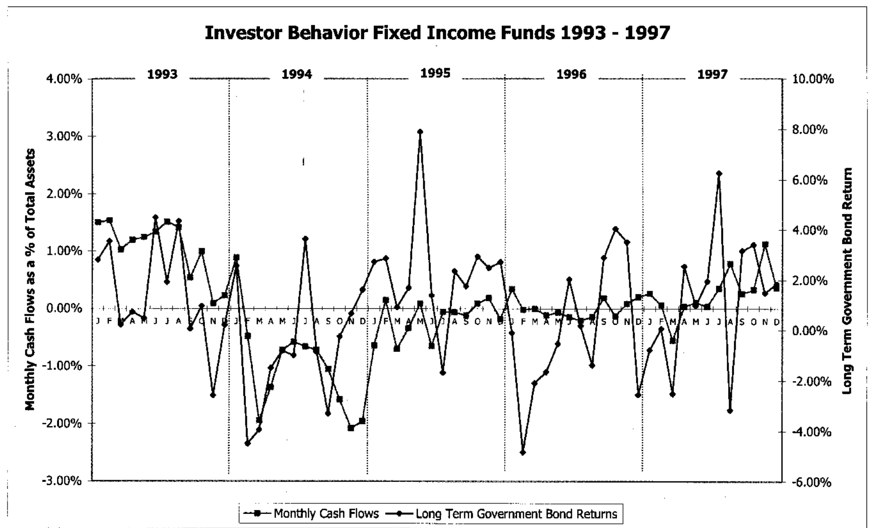
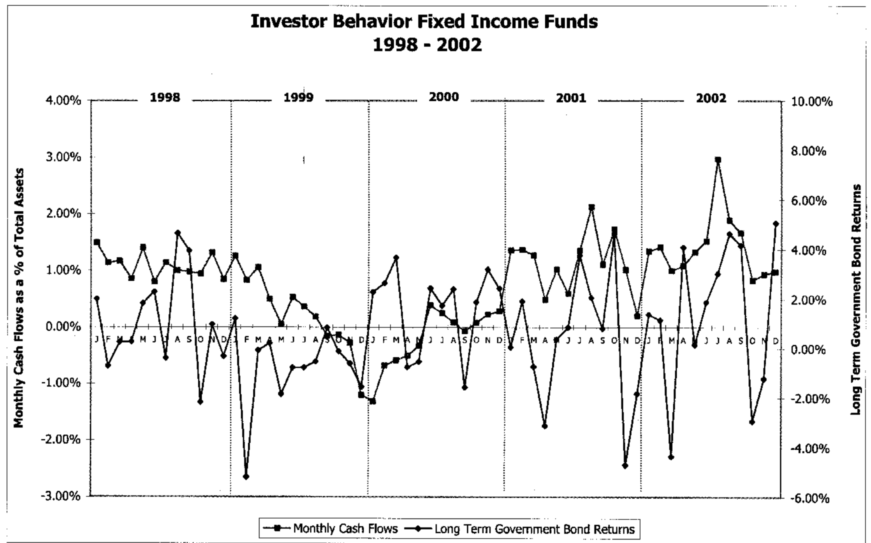

Investor Behavior Fixed Income Funds 1984 - 1987*
1984
1985
1986
1987
10.00%
8.00%
6.00%
4.00%
2.00%
0.00%
-2.00%
-4.00%
Monthly Cash Flows as a % of Assets
14.00%
12.00%
10.00%
8.00%
6.00%
4.00%
2.00%
0.00%
-2.00%
-4.00%
-6.00%
Long Term Government Bond Return
J F M A M J J A S O N D
Monthly Cash Flows
Long Term Government Bond Returns

DALBAR
The Measurement of Success



DALBAR
The Measurement of Success




Investor Behavior Fixed Income Funds
1998 - 2002
1998
1999
2000
2001
2002
4.00%
3.00%
2.00%
1.00%
0.00%
-1.00%
-2.00%
-3.00%
Monthly Cash Flows as a % of Total Assets
10.00%
8.00%
6.00%
4.00%
2.00%
0.00%
-2.00%
-4.00%
-6.00%
Long Term Government Bond Returns
Monthly Cash Flows
Long Term Government Bond Returns

Appendix C – Trade Volume

The following appendix displays trade volume for equity and fixed income funds from 1984 – 2002 and compares it to an appropriate market index. Trade Volume consists of sales, redemptions, and exchanges.

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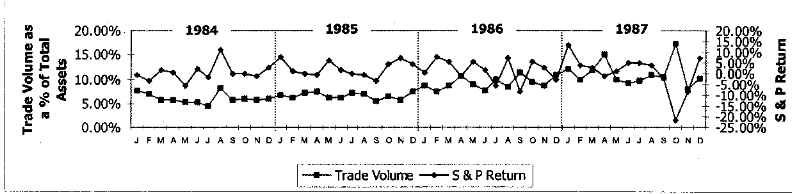
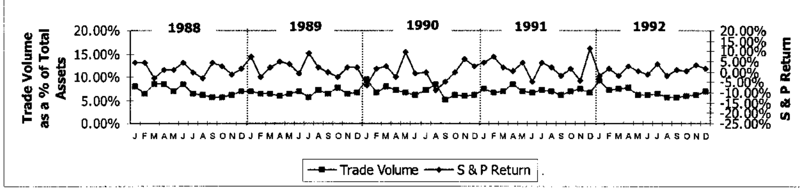
Equity Fund Trade Volume Overview

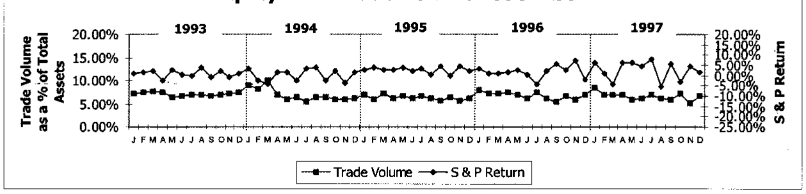
Equity Fund Trade Volume 1984 - 1987



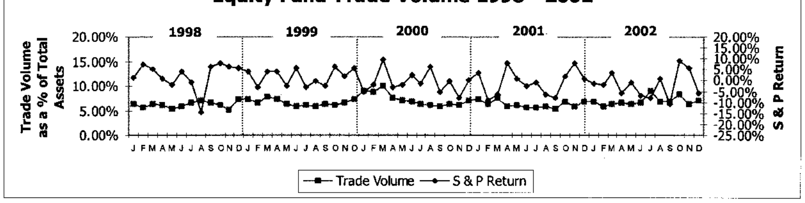
Equity Fund Trade Volume 1988 - 1992

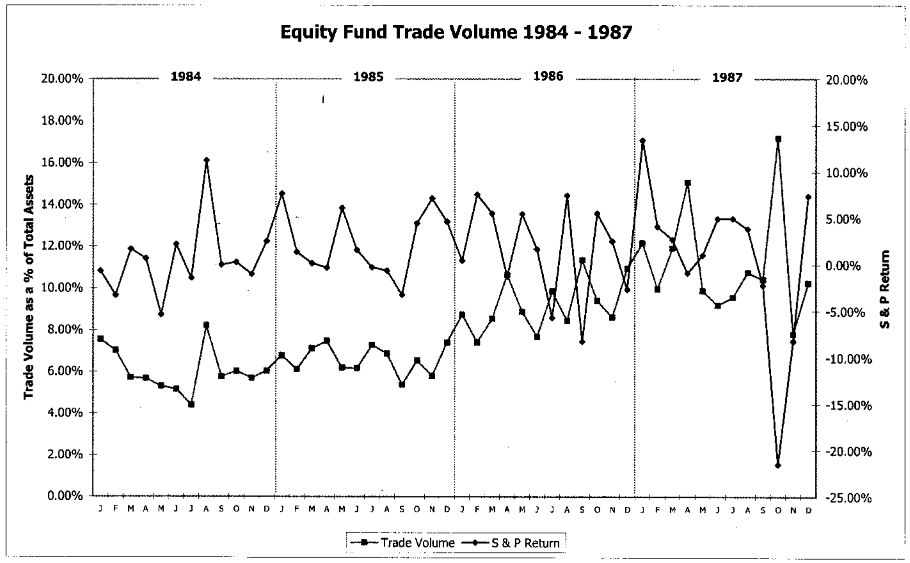


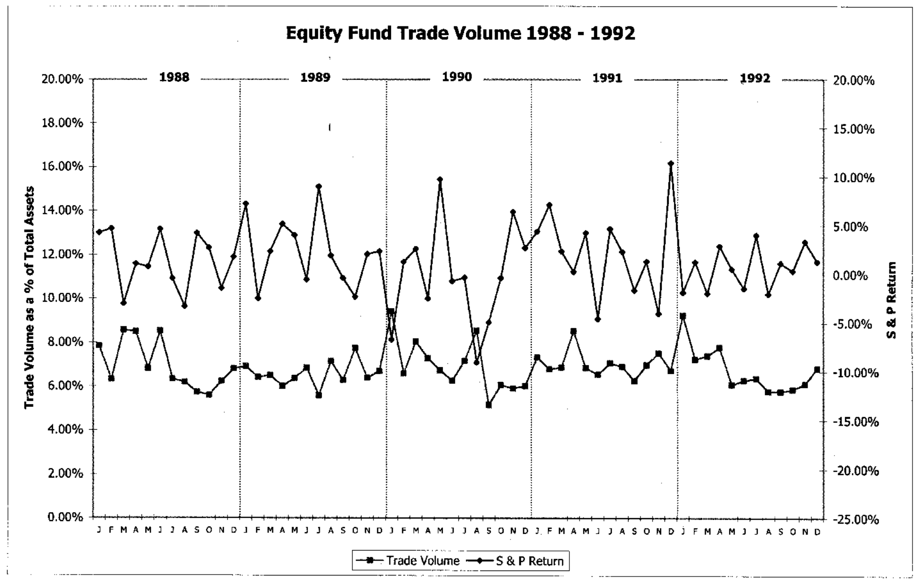
Equity Fund Trade Volume 1993 -1997



Equity Fund Trade Volume 1998 - 2002




Equity Fund Trade Volume 1984 - 1987
1984
1985
1986
1987
Trade Volume as a % of Total Assets
20.00%
18.00%
16.00%
14.00%
12.00%
10.00%
8.00%
6.00%
4.00%
2.00%
0.00%
S & P Return
20.00%
15.00%
10.00%
5.00%
0.00%
-5.00%
-10.00%
-15.00%
-20.00%
-25.00%
J F M A M J J A S O N D J F M A M J J A S O N D J F M A M J J A S O N D J F M A M J J A S O N D
Trade Volume
S & P Return


Equity Fund Trade Volume 1988 - 1992
1988
1989
1990
1991
1992
Trade Volume as a % of Total Assets
20.00%
18.00%
16.00%
14.00%
12.00%
10.00%
8.00%
6.00%
4.00%
2.00%
0.00%
S & P Return
20.00%
15.00%
10.00%
5.00%
0.00%
-5.00%
-10.00%
-15.00%
-20.00%
-25.00%
J F M A M J J A S O N D J F M A M J J A S O N D J F M A M J J A S O N D J F M A M J J A S O N D J F M A M J J A S O N D
Trade Volume
S & P Return

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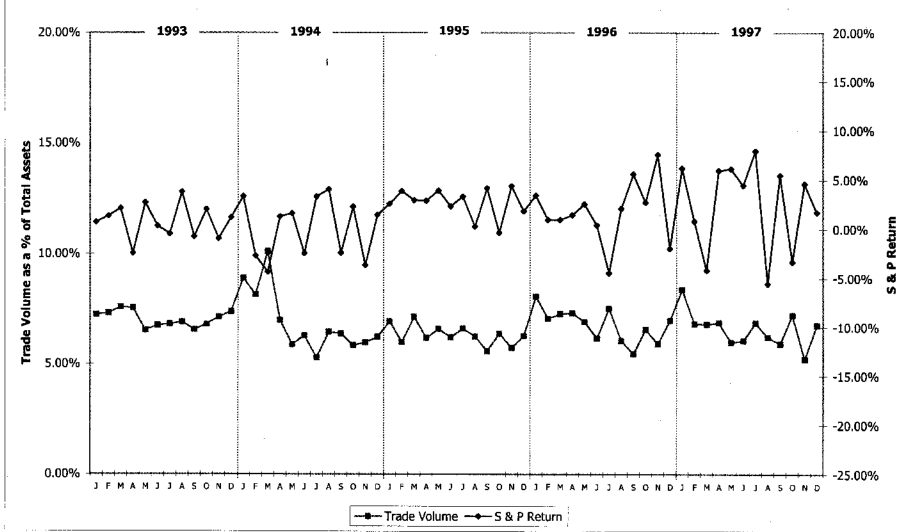
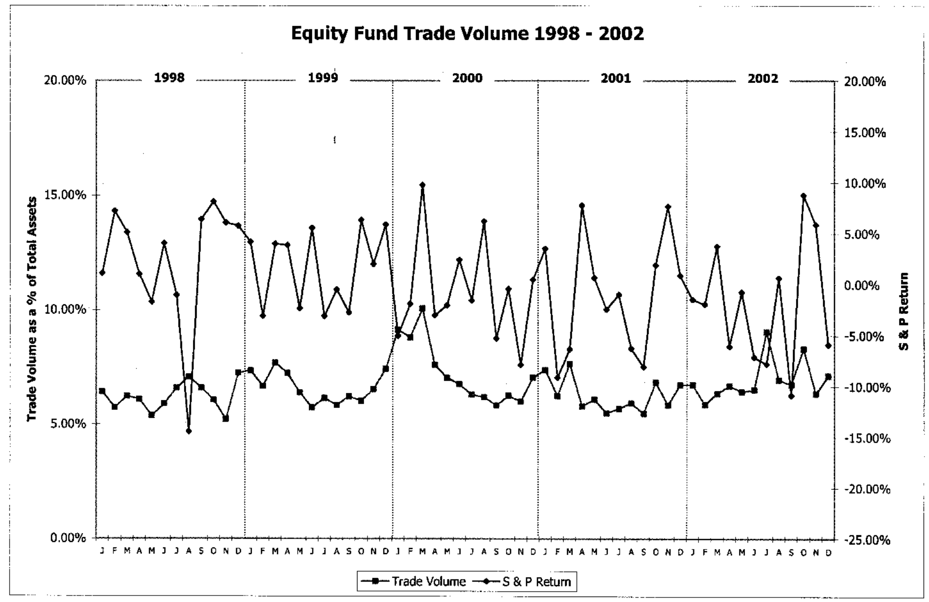
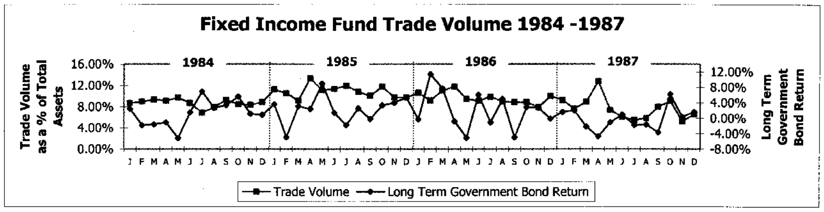
Equity Fund Trade Volume 1993 -1997

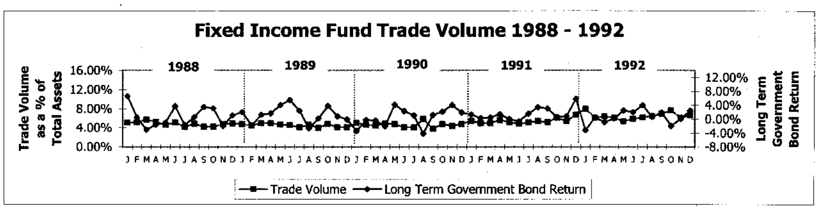


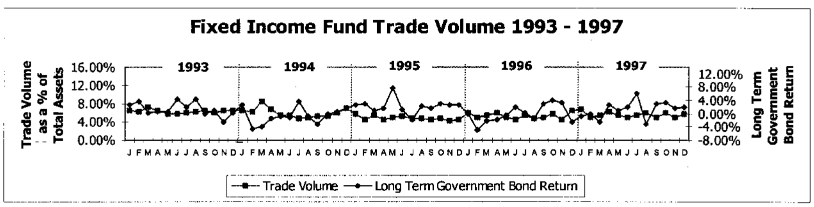

Equity Fund Trade Volume 1998 - 2002
1998
1999
2000
2001
2002
20.00%
15.00%
10.00%
5.00%
0.00%
Trade Volume as a % of Total Assets
20.00%
15.00%
10.00%
5.00%
0.00%
-5.00%
-10.00%
-15.00%
-20.00%
-25.00%
S & P Return
J F M A M J J A S O N D J F M A M J J A S O N D J F M A M J J A S O N D J F M A M J J A S O N D J F M A M J J A S O N D
Trade Volume
S & P Return

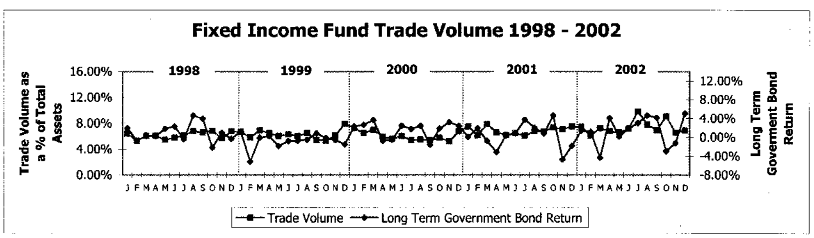
DALBAR
The Measurement of Success

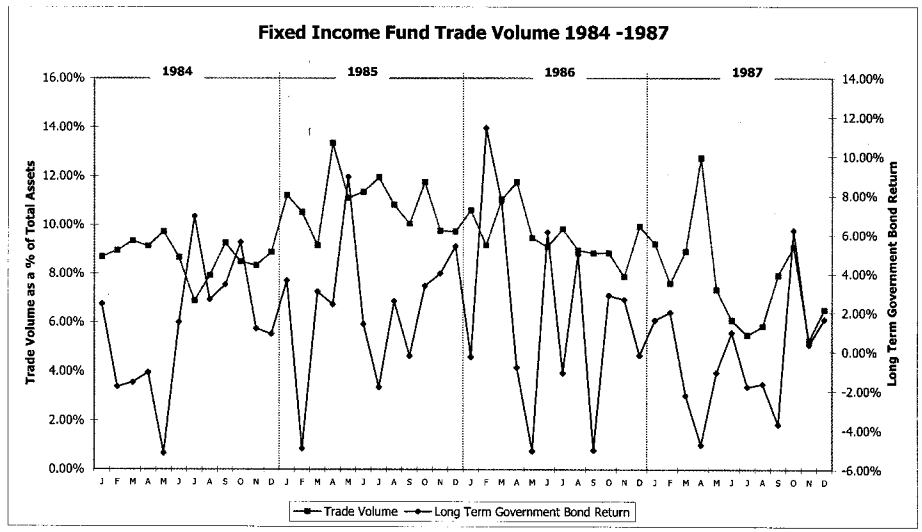
Fixed Income Fund Trade Volume Overview

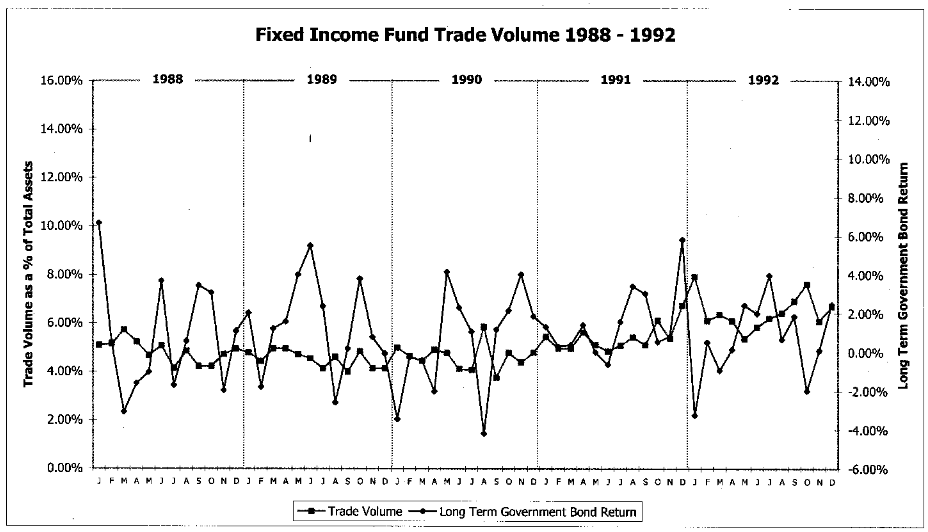


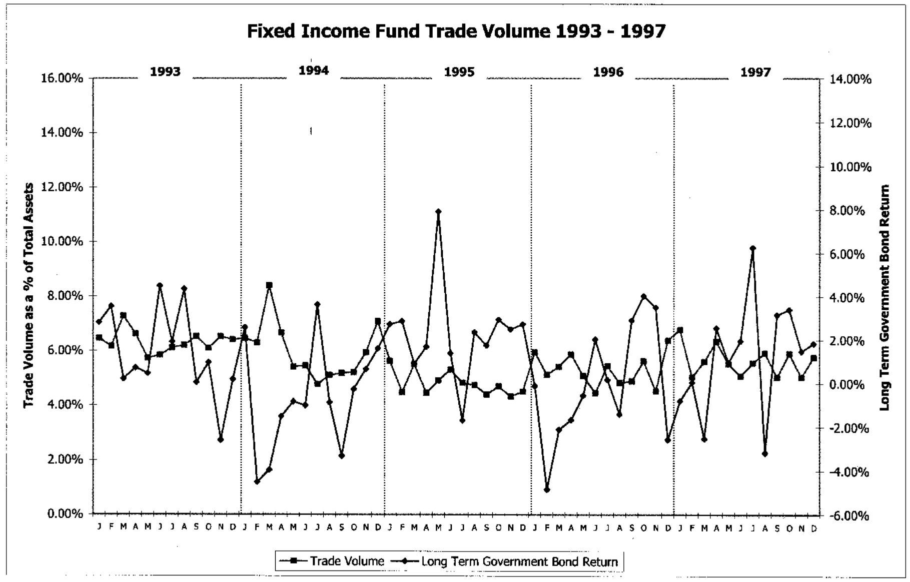


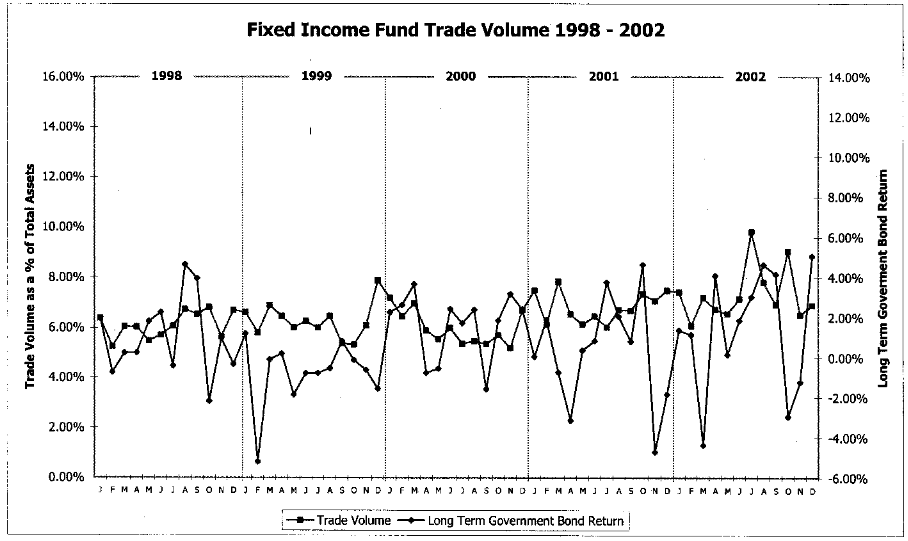





Fixed Income Fund Trade Volume 1984 -1987
1984
1985
1986
1987
16.00%
14.00%
12.00%
10.00%
8.00%
6.00%
4.00%
2.00%
0.00%
Trade Volume as a % of Total Assets
14.00%
12.00%
10.00%
8.00%
6.00%
4.00%
2.00%
0.00%
-2.00%
-4.00%
-6.00%
Long Term Government Bond Return
J F M A M J J A S O N D J F M A M J J A S O N D J F M A M J J A S O N D J F M A M J J A S O N D
Trade Volume
Long Term Government Bond Return


Fixed Income Fund Trade Volume 1988 - 1992
1988
1989
1990
1991
1992
16.00%
14.00%
12.00%
10.00%
8.00%
6.00%
4.00%
2.00%
0.00%
Trade Volume as a % of Total Assets
14.00%
12.00%
10.00%
8.00%
6.00%
4.00%
2.00%
0.00%
-2.00%
-4.00%
-6.00%
Long Term Government Bond Return
J F M A M J J A S O N D J F M A M J J A S O N D J F M A M J J A S O N D J F M A M J J A S O N D J F M A M J J A S O N D
Trade Volume
Long Term Government Bond Return


Fixed Income Fund Trade Volume 1993 - 1997
1993
1994
1995
1996
1997
16.00%
14.00%
12.00%
10.00%
8.00%
6.00%
4.00%
2.00%
0.00%
Trade Volume as a % of Total Assets
14.00%
12.00%
10.00%
8.00%
6.00%
4.00%
2.00%
0.00%
-2.00%
-4.00%
-6.00%
Long Term Government Bond Return
J F M A M J J A S O N D J F M A M J J A S O N D J F M A M J J A S O N D J F M A M J J A S O N D J F M A M J J A S O N D
Trade Volume
Long Term Government Bond Return


Fixed Income Fund Trade Volume 1998 - 2002
1998
1999
2000
2001
2002
Trade Volume as a % of Total Assets
16.00%
14.00%
12.00%
10.00%
8.00%
6.00%
4.00%
2.00%
0.00%
Long Term Goverment Bond Return
14.00%
12.00%
10.00%
8.00%
6.00%
4.00%
2.00%
0.00%
-2.00%
-4.00%
-6.00%
J F M A M J J A S O N D J F M A M J J A S O N D J F M A M J J A S O N D J F M A M J J A S O N D J F M A M J J A S O N D
Trade Volume
Long Term Government Bond Return

MUTUAL FUND BROKERAGE COMMISSIONS

January 2004

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Abstract

The Zero Alpha Group (ZAG) has commissioned us to examine the magnitude of brokerage commissions paid by mutual funds. This report represents a first, exploratory phase of a larger ongoing study of mutual fund brokerage commissions. We have conducted analysis using two data sources. We find that brokerage commissions are significant, averaging 27 basis points in 2001. Lower turnover funds have lower commissions while higher turnover funds exhibit much higher commissions. Due to the magnitude of these costs and their variability from fund to fund, we suggest that the SEC require funds to report commissions in a prominent location in the mutual fund prospectus.

MUTUAL FUND BROKERAGE COMMISSIONS

Introduction

Expense ratios

Mutual funds have become the primary mode of investing for a large portion of the US population. As of November 2003, the Investment Company Institute estimates that over $7 trillion was invested in mutual funds. The primary advantage to investing via mutual funds is that they provide even small investors with the ability to build diversified portfolios. A more disputable, but often mentioned advantage is the professional management afforded by holding mutual funds rather than individually directed investment in the equity or bond markets. The clear advantage of diversification and the more dubious benefit of professional management come at a cost to investors.

The mutual fund itself is simply a portfolio of securities. A number of service providers must be hired to perform the various functions that are necessary for the operations of the fund to run smoothly. These service providers include the fund management company (which makes the day-to-day investment decisions for the fund portfolio), the fund distribution company (which sells the fund shares either wholesale to brokers or retail to individual investors), the custodian (which keeps the portfolio securities in safe-keeping), the transfer agent (which maintains the records of the investors in the funds), attorneys (which write prospectuses and legal forms required by the SEC) and accountants (which audit the financial statements of the fund). All of these service providers enter into contracts with the mutual fund that are negotiated by the fund directors. The fees that these service providers earn are paid out of the net assets of the mutual fund on a periodic basis. Though paid periodically throughout the year, most investors are familiar with these fees as aggregated and quoted as an annualized percentage of the net assets in the fund -- the mutual fund expense ratio.

The SEC requires full disclosure of fund expense ratios. Prospectuses that fund families send to investors have information on the expense ratio near the front of the document. The SEC does not assess the reasonableness of these fees, but certainly the expense ratio is easy for investors to find and to compare across different potential mutual fund investments

Because of the availability of information on expense ratios, many studies of them have been conducted. The more rigorous academic studies find that expense ratios generally detract from fund performance. On average, fund managers are unable to recoup the expenses that funds pay via better performance. These findings suggest that basing fund investment decisions at least partially on fees is wise. Lower cost funds have a smaller drag on performance that active managers must overcome. Taken to their logical conclusion, these results may suggest that index funds, accompanied by the lowest expense ratios in the mutual fund industry, are a more logical long-run investment choice than more expensive actively-managed funds.

Costs of trading

Although expense ratios capture the contracted fees that investors bear by investing in mutual funds, there is an additional, less visible cost of mutual fund investment – the cost of portfolio trading. When an equity fund manager directs a trade for a fund portfolio, the trade generally incurs a commission. This commission is identical conceptually to the commission that an investor would pay to a broker for buying or selling a stock. However, because the fund is a large, institutional investor, it normally receives lower percentage commissions than an individual investor. In fact, it is just this lower cost of trading that allows mutual funds to offer efficient diversification to investors who may not be able to achieve it cost-effectively on their own.

Although it is less apparent to investors, trading also exposes investors to implicit costs. Contrary to the idea that there is a single price at any given time for a specific stock, there are actually two prices – one for buying the stock and one for selling the stock. The difference between these prices is called the bid-ask spread. Therefore, if you simultaneously bought and sold 100 shares of a stock, you would actually incur a small loss even absent a trading commission. This loss occurs because you must buy at the higher of the two prices (the ask) and sell at the lower of the two (the bid). An additional implicit cost is that a mutual fund, as a large investor, may actually move the prices of the stocks in which it transacts. If a fund wishes to sell a very large amount of a stock, this significant selling pressure may actually reduce the price at which the fund is able to sell the stock (which is obviously bad for the fund). This change in the stock price that is driven by large trades is called market impact.

Portfolio trading in a mutual fund therefore exposes the fund shareholder to explicit commissions and implicit bid-ask spreads. The shareholders completely incur these costs because the assets of the portfolio are valued net of these costs. The costs are not paid by the fund manager. The explicit commissions are easy to measure. Funds keep records of these commissions and report them to the SEC. The implicit costs are much more difficult to ascertain, although methods for measuring these are continually being refined. These estimated implicit costs are not reported by mutual funds. Because of their availability, the actual commissions paid by funds are studied in the empirical section of this paper. We do not empirically investigate implicit trading costs although we estimate their levels with data from previous studies of these costs.

Surprisingly, commission levels do not appear in most fund prospectuses and therefore most investors are completely unaware of the magnitude of these costs of trading. Depending on the amount of trading that a manager directs for the mutual fund portfolio, the commissions can be significant. The purpose of this study is to demonstrate the magnitudes of trading commissions. Because of the difficulty in obtaining data, this study will just scratch the surface of this issue. A more rigorous follow-up study will present more complete evidence for the level of trading commissions in the mutual fund industry.

Issues

The Difficulty of Obtaining Data

Anyone trying to objectively examine the level of mutual fund brokerage commissions is immediately struck by the difficulty of obtaining data on these commissions. Mutual fund brokerage commissions are reported in two ways to the SEC. First, the SEC requires mutual funds to report their brokerage commissions in a supplement to the prospectus entitled the Statement of Additional Information (SAI). Second, mutual funds report brokerage commissions in electronic format in a semiannual filing of form NSAR.

The SAI is a document that contains information about a mutual fund which is not found in the prospectus. Investors will only see an SAI if they request it. However, since most investors likely do not know that it exists, they never see this document. In addition to having hard copies of the SAI on hand to honor investor requests, mutual funds also file the SAI electronically with the SEC. The SAI is generally found as an attachment to the fund registration statement, which is required to be filed on a semiannual basis. Some mutual funds choose to report their brokerage commissions in the main part of the prospectus as well, but this is not required by the SEC.

Therefore, an investor wishing to use the SAI to gather information on brokerage commissions must either request the hard-copies of the SAI from the fund company, or attempt to access the SAIs via the SEC's Edgar database. As most investors are not aware, fund families do not file forms with SEC for each individual fund in the family. Most often, several funds are grouped together into an entity called a "registrant" for purposes of filing. Therefore, a filing contains information on all of the funds in the registrant, not just the particular fund that an investor may be considering. While filing at the registrant level is less costly for fund families, it makes the job of extracting information for individual funds more difficult for investors. Many of the electronic registration statements, to which the SAI is attached, are over 100 pages long.

Mutual funds are also required to report their brokerage commissions in an electronic form called form NSAR. As with other filings with the SEC, mutual fund families are permitted to file NSAR reports for registrant groups of mutual funds within the family. Unfortunately, a registrant is required only to report total brokerage commissions on an aggregate basis for all of the funds in a filing. The registrant is not required to report brokerage commissions for each individual fund. Conceivably, the mutual funds in the filing for a registrant may have markedly different brokerage commissions. Attempts to extract accurate brokerage commission information from the NSAR are therefore subject to potential errors.

Soft Dollars

In an ideal world, the advisory fee should be full compensation to an investment adviser for research and advice. Brokerage commissions should be paid only for execution of orders to buy or sell. In practice at the institutional level, brokerage commissions frequently include payment for services in addition to order execution. Such payments are termed soft dollar arrangements. These payments may be for research provided to the advisers, access to information sources, computer equipment, and even personal services. The complication that soft dollars introduces for our purposes is that in the presence of soft dollar arrangements, measured commissions include a component

that is not specifically for execution of trades. We have no way to extract that portion of commissions that might be paid for research. More broadly, most investors are unaware of these practices. Investors likely believe that the research that is conducted by fund managers is paid for out of the fees resulting from the contracts that the board of directors negotiates with the fund managers. Soft dollars in effect represent a way for the manager to avoid paying for research out of contracted fee with the fund and allow the manager to keep as profits a greater portion of the fee. In our view, the mutual fund advisers should be fully compensated through their advisory fee, and they should not pay for research and other services through brokerage commissions, since brokerage commissions are an additional direct charge to fund investors. Brokerage commissions should be reported on an individual fund basis in the mutual fund Prospectus and electronically to the SEC in the NSAR reports. To the extent that soft dollar arrangements are in effect, the brokerage commissions should be divided into their components, that is, execution, research and other services.

The argument against reporting brokerage commissions is that the total cost of trading is only partially represented by brokerage commissions. The spreads and market impact mentioned previously are an additional cost. Conceivably, a trade could have low brokerage commissions, but a large market impact, and the total cost could be considerable. Spreads and market impact are not easily measured. In contrast, brokerage commissions are directly observed and measurable, and reporting detailed brokerage commissions would provide investors with more information and would have no adverse consequences. The SEC has a responsibility to require full disclosure of all fees and expenses, since the clientele for mutual funds may be relatively unsophisticated. Brokerage commissions are currently an exception to the SEC's full disclosure doctrine.

Empirical Analysis

Data and Sample

We utilized two sets of data. First, we collected every NSAR report that was electronically filed with the SEC for fiscal year 2001. This data reports brokerage commissions at the registrant level and therefore does not allow the analysis of individual mutual funds. However, since this data is filed in a consistent electronic format with the SEC, it better lends itself to exhaustive analysis. One purpose of using this dataset is to gauge the errors introduced by attempting to estimate individual fund-level commissions with registrant-level commissions.

The second set of data was hand-collected for a small sample of mutual funds from the Statements of Additional Information. This data, though not exhaustive, at least gives us some insight into the brokerage commissions of individual mutual funds. We collected the brokerage commissions for the 30 of the largest domestic equity mutual funds in 2001. We consulted Morningstar's Principia Pro Plus database to find these largest funds. We deleted institutional funds and concentrated only on the retail funds. For several funds, we were unable to find all of the information we needed for the subsequent analysis. Hence, our sample is the 30 largest retail funds for which we could locate all of the relevant information. These funds are listed in the attached Excel spreadsheet.

We also found in the Morningstar database the domestic equity funds with the highest turnover ratios. Turnover ratio is an indicator of the amount of trading activity of a mutual fund. We identified 10 of the funds with the highest turnover ratios that also had at least $100 million in assets. We found that many of the highest turnover funds were quite small. However, for this study we wished to identify funds that had significant assets under management.

Results – brokerage commissions

After culling the NSAR dataset for domestic equity funds, we were left with 3,330 funds. Note that the NSAR data correctly reports multiple class funds as a single fund portfolio. The data reports brokerage commissions in dollars for the entire registrant which is simply the sum of the brokerage commissions incurred by each fund in the registrant. However, since we did not know those individual fund commissions, we were forced to employ an ad hoc method for allocating the brokerage commissions across the funds. Our first method simply allocates the dollar level of the registrant's commissions across the individual funds according to the net assets of the fund. Larger funds are allocated a larger percentage of the commissions. This method causes every fund in the registrant to have the same percentage brokerage commission rate. Large funds are allocated larger commissions, but when divided by net assets, the percentage that these commissions represent of the net assets of the fund are the same as we would find for a small fund in the same registrant.

The second method allocates commissions according to an estimate of the dollar amount of trading each fund in a registrant executed. We estimated the total amount of trading that a fund executed over the year by multiplying the average net assets of the fund by the fund turnover. Summing these estimated trading numbers across all funds in the registrant results in a total amount of trading for the registrant. We then allocated the dollar brokerage commissions to each individual fund in the registrant according to the percentage of total registrant trading accounted for by the fund.

We find evidence of significant data errors in the NSAR filings. For example, one registrant had an entry for brokerage commissions that was 10 times the total assets under management at the fund. This is clearly a data error. An additional 16 funds had commissions that were greater than net assets. A total of 54 funds had commissions that were greater than 5% of net assets. Though we do not know with certainty that all of these are erroneous, we delete these observations from the sample before reporting mean statistics. Thus our sample consists of 3,276 funds.

The average commission rate when allocated via the turnover method is 27.2 basis points. Thus number is remarkably close to the 27.9 basis points found by Livingston and O'Neal (1996) in a study of mutual fund brokerage commissions from the 1989-93 time period. This suggests that the average fund incurs just over a quarter of a percentage point in commissions due to trading each year. As mentioned earlier, this does not represent the entire cost of trading because market impact and bid-ask spreads are not considered here. Academic researchers have suggested that commissions represent less than half of the total cost of trading for institutional investors. Therefore,

while commissions represent a quarter of a point per year for the average fund, total trading costs likely surpass a half of a percentage point for the average fund.

When the brokerage commissions are allocated purely on net assets without regard for the turnover of the individual funds, the average commissions are 18.9 basis points. Using only net assets to allocate commissions gives larger funds greater weight in the analysis. The lower average commission number suggests that larger funds, on average, trade less than smaller funds. The findings overall suggest that the average investor incurred 18.9 basis points in commissions in 2001 but that the average fund paid 27.2 basis points. Since more investors are in larger funds (by definition), more investors are exposed to the relatively lower turnover of large funds.

We have some reservations about the use of this data to draw over-arching conclusions. First, it appears as though the data is subject to errors. Although we delete outliers, there may still be errors in this data. It is also possible that some of the observations we delete are, in fact, valid. Second, we are forced to allocate commissions across the funds in a registrant. The ad hoc measures we construct are the best we can do with the data we have. However, suppose that half the funds in a registrant are large cap and half are small cap. It is very likely that the two types of funds will face different commission structures for trading the stocks in their portfolios. We cannot control that difference. While these two problems cannot be overcome, we do note that the average commissions are very close to the only previous study of mutual fund commissions that has been published. The real problem is that the data cannot be used to look at individual funds. Although we have some confidence in our overall averages, we would not have much confidence at all about individual fund commissions calculated from this data.

Because of our reservations about the data in form NSAR, we also collect some data from Statements of additional information. For the 30 largest domestic equity funds, the average brokerage commissions are 10.2 basis points. This is significantly less than the numbers we found using the NSAR data. We believe that two factors are at work. First, these larger funds may be able to negotiate lower brokerage commissions due to the shear volume of trades that they bring to brokers. Second, these funds have significantly lower turnover than the average fund. For 2001, Morningstar data shows that turnover for the average domestic equity fund was 106%. The average turnover for these largest 30 funds is 57% - half that of the average fund. There are 3 index funds in this sample of 30. If we separate these out, the average commission rate for the actively managed funds is 11.3 basis points. This contrasts to an average of .45 basis points for the index funds.

Exhibit 1 shows a graph of turnover vs. brokerage commissions for this sample of 30 funds. The strong positive correlation between turnover and brokerage commissions is evident from this graph. The three observations clustered in the lower left-hand corner of the graph are the index funds. If you run a simple regression of brokerage commissions on turnover, the R-square is 73% and the t-statistic on turnover is 8.6. These statistics simply mean that turnover is a very strong determinant of brokerage commissions.

The second small group of funds for which we collect brokerage commissions is 10 funds with very high turnover in 2001. These 10 funds were selected as follows. First, the 200 funds with the highest turnover were culled from Morningstar. Then, all funds in this list of 200 which had assets less than $100 million were deleted. The resulting sample was 82 funds. From this list, 10 funds were randomly selected. The

funds in this sample of 10 averaged $777 million in assets. The average turnover ratio in 2001 for these funds was 498%. The range of brokerage commissions as a percent of assets was 1.67%. Clearly the brokerage commissions for these funds are higher than the average fund. However, this analysis demonstrates that even some fairly large funds can have brokerage commissions that are as large as their expense ratios. As mentioned earlier, the total cost of trading is likely much higher than this because of the implicit costs which we have not measured here.

Estimated bid-ask spreads

As discussed in earlier sections, implicit costs of trading are more difficult to measure than are explicit commissions. However, previous researchers have generally concluded that the implicit trading costs are at least as large as the explicit costs. In this section, we apply estimated implicit costs from the SEC's Report on the Comparison of Order Executions Across Market Structures that was published in 2001. The primary purpose of the SEC study was to identify differences in execution costs on NYSE and NASDAQ stocks, but their findings also allow us to estimate the likely implicit trading costs facing mutual funds.

Consistent with other research studies, the SEC study measures implicit trading costs in several ways. The one that we concentrate on here is called the effective spread. The effective spread is two times the difference in the price at which the trade is executed and the midpoint between the quoted bid and ask spread at the time the trade is executed. This method estimates that the "true" value of the security is the price immediately in-between the prices at which you can buy (ask) and sell (bid) the stock. If you indeed purchase at the ask price or sell at the bid price, then this method of measuring implicit costs is the same as the quoted spread. However, it turns out that many purchases and sales of stocks occur at prices that are better than the quoted bid or ask price. The effective spread takes into account this "price improvement" that may occur on orders. Multiplying by two simply transforms the spread into an estimate of "round-trip" implicit costs

The second method for measuring implicit costs of trading is called the realized spread. The realized spread is two times the difference between the price that the transaction occurs and the midpoint of the spread 5 minutes after the trade is executed. This measure takes into account that the initiator of the trade has some valuable information about the stock that necessitates the trade. The trade itself conveys that information or the information is released from some other source causing the stock price to move in a favorable direction for the trader (up in the case of a buy, down in the case of a sale). Supporters of the realized spread as a measure of trading cost presume that the trade price should be measured relative to this full-information price.

As mentioned, many studies have analyzed the characteristics of effective and realized spreads. We choose to use the estimates from the SEC study because the time period in that study (June, 2000) most closely matches the period for which we have brokerage commission data. Most of the published academic data draw on data from earlier periods.

The SEC study looked at representative stocks from both NASDAQ and the NYSE. The study segmented the data by size of the stock being traded (market

capitalization) and the size of the trade (number of shares) being executed. Typically, spreads are larger for smaller stocks and larger orders. Since our purpose is to estimate costs for mutual funds which likely trade in larger blocks, we use the largest trade category (2000-4999 shares) in the SEC study. We also concentrate on trades in very large stocks (the study categorizes stocks as very large, large, middle and small).

Effective spreads on market orders are estimated at 14 cents per share for NASDAQ stocks and 18 cents per share for NYSE stocks.[1] The average closing price of the stocks in the NYSE in 2000 was $42. Taking this average closing price, we can calculate the spreads in basis points. If we use 15 cents per share as a reasonable estimate of the effective spread, the effective spread is 36 basis points per trade. A fund with a turnover ratio of 100% would thus incur 36 basis points per year in implicit trading costs.

If we apply the 36 basis point per trade implicit cost to the turnover ratios for mutual funds we can estimate the implicit trading cost of mutual funds. For the sample of 30 large domestic equity funds, the average turnover ratio was approximately 57% in 2001. The average implicit costs of trading are thus 20 basis points for the average large domestic equity fund. When combined with the 10 basis points in average commissions, the total costs of trading are close to 30 basis points for large domestic equity funds. This suggests that the all-in costs of trading are 43% as large as the expense ratio for large equity funds. Exhibit 2 shows the cost break-down for 4 representative large equity funds. It should be emphasized that the implicit costs are estimated and may be different from the costs actually incurred by these mutual funds.

For the sample of 10 high turnover funds, the implicit costs of trading are obviously much higher than for the sample of large funds. We estimate the average implicit trading costs for these 10 funds to be 1.91% per year. Exhibit 3 presents the total costs of investing in four of these 10 funds.

Conclusion

This report represents a first, exploratory phase of an ongoing study of mutual fund trading costs. Our first important conclusion is that the reporting requirements for mutual funds vis a vis brokerage commissions are inadequate. Investors should be provided with this information in the prospectus because it is very difficult to access on line. It is infeasible for an investor to make any sort of reasonable attempt to compare brokerage commissions across funds.

We have presented some interesting statistics regarding the level of brokerage commissions using two separate data collection techniques. We estimate the commissions at the average fund at 27 basis points per year. Commissions appear to be lower for the largest equity funds. This is because the largest funds in 2001 had low turnover and because they likely obtain volume discounts from brokers. There is a significant relationship between the amount of trading that a fund undertakes and the

[1] Bessembinder (*Journal of Financial Markets* 6 (2003), pp. 233-257) finds that effective spreads are approximately 10 cents per share for NYSE stocks and 20 cents per share for NASDAQ stocks using data from 1998. Bessembinder calculates half-spreads which we multiply by two to make them comparable to the SEC calculation method. This data comes table 6, page 247.

level of brokerage commissions the fund incurs. Since the largest funds exhibited low turnovers, we also identified a subset of medium-sized high turnover funds. This small subset incurred brokerage commissions that averaged 1.65% of assets in 2001.

Because brokerage commissions are so variable across funds, and because they are a cost incurred by shareholders, we suggest that they be reported in a visible section of the prospectus. Preferably these commissions should be reported along with the other expenses investors incur.

We also used estimates of typical effective spreads to gauge the level of implicit costs that are incurred by mutual fund investors. Our estimates suggest that the implicit costs are likely higher than the brokerage commissions. For the sample of large domestic equity funds, we estimate that investors are incurring 20 basis points per year in implicit trading costs. These costs are meaningful when compared to reported fund expense ratios. For the high turnover funds, the estimated implicit costs are much higher. Together, the commissions and implicit costs are higher than the published expense ratios for each of the 10 high turnover funds we studied. In some cases, the total costs of trading are more than double the level of the expense ratio.

References

Miles Livingston and Edward O'Neal, "Mutual Fund Brokerage Commissions," Journal of Financial Research, Summer 1996, Vol. XIX, No. 2, pp 273-292.

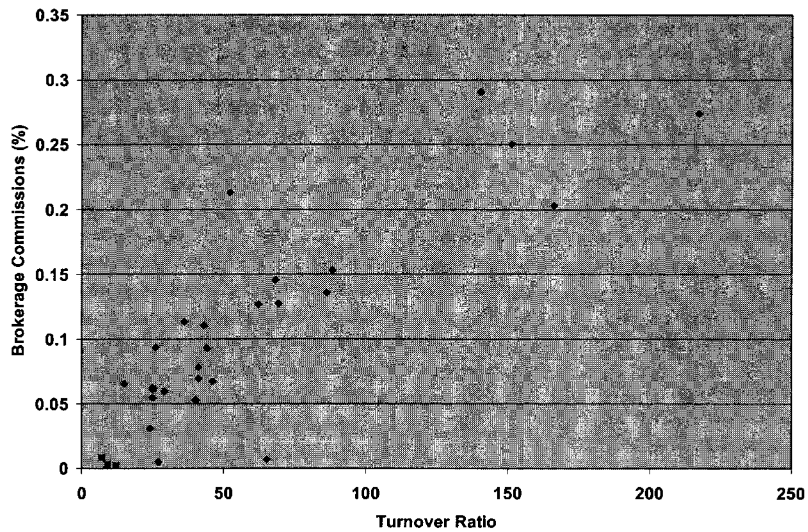


Exhibit 1: The relationship between brokerage commissions and turnover for the 30 largest retail domestic equity funds in 2001.

Exhibit 2: Total 2001 costs of investing: 4 representative large equity funds

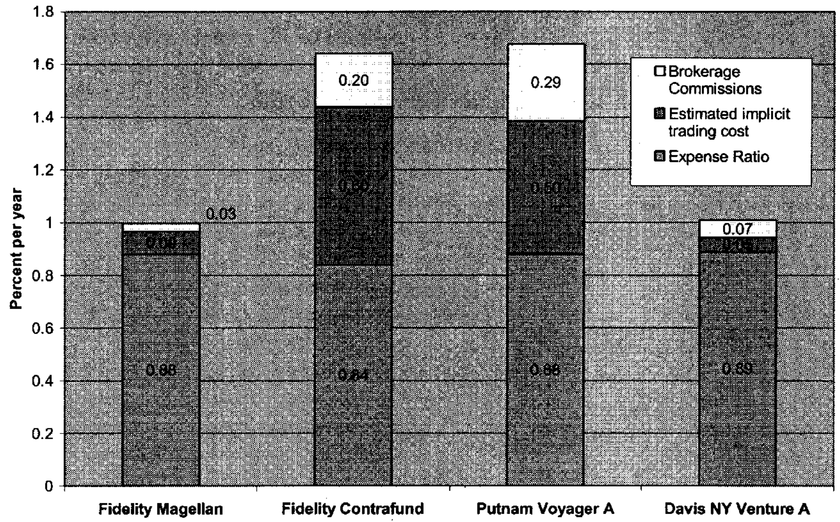
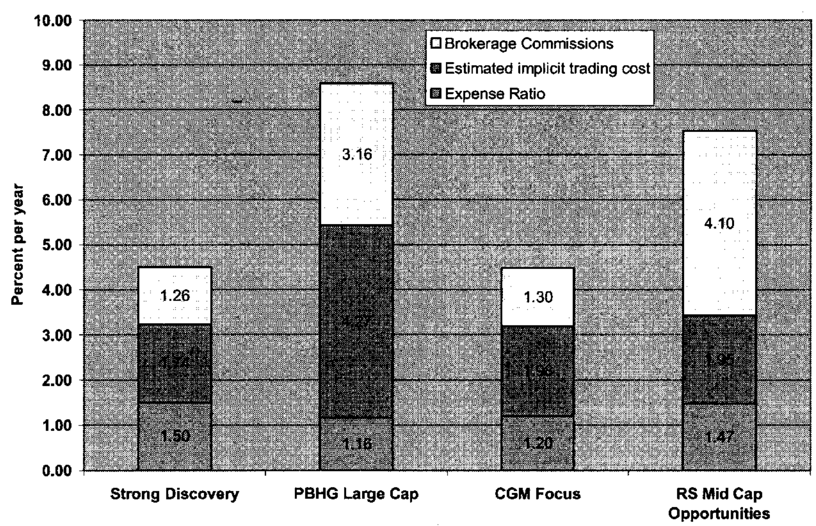


Exhibit 3: Total 2001 costs of investing in high turnover equity funds with total net assets greater than $100 Million



Columns B through G from Morningstar Principia Pro January 2002 version

Fund Name	Fund Family	Prospectus Objective	Exp Ratio	12b-1 Current	Turn Ratio	Net Assets $MM	Avg NA (from SEC's NSAR database - avg mon NA)	Brok Comm (thous) - from SAI	Brok comm as % of avg NA	Exp Ratio	Estimated implicit trading cost (avg effective spread (15cents /36 basis points) on trades times turnover ratio)	Brok Comm	Total costs
Fidelity Magellan	Fidelity Group	Growth	0.88	0	24	79515.2	99247	30522	0.0308	0.88	0.0864	0.0308	0.9972
Vanguard 500 Index	Vanguard Group	Grw & Inc	0.18	0	9	73150.8	88772	2718	0.0031	0.18	0.0324	0.0031	0.2155
American Funds Inv Co Amer A	American Funds Group	Grw & Inc	0.56	0.23	25	54008.1	55000	33426	0.0608	0.56	0.09	0.0608	0.7108
American Funds Wash Mutual A	American Funds Group	Grw & Inc	0.65	0.24	25	48135.1	49000	30517	0.0623	0.65	0.09	0.0623	0.8023
American Funds Growth Fund A	American Funds Group	Growth	0.71	0.25	36	35402	37000	41952	0.1134	0.71	0.1296	0.1134	0.9530
Fidelity Growth & Income	Fidelity Group	Grw & Inc	0.66	0	41	34255.1	38822	26967	0.0695	0.66	0.1476	0.0695	0.8771
Fidelity Contrafund	Fidelity Group	Growth	0.84	0	166	32320.9	36000	73137	0.2032	0.84	0.5976	0.2032	1.6408
American Cent Ultra Inv	American Century	Growth	0.99	0	62	26911.4	31353	39761	0.1268	0.99	0.2232	0.1268	1.3400
Janus	Janus	Growth	0.84	0	65	25621.8	34254	2370	0.0069	0.84	0.234	0.0069	1.0809
Fidelity Growth Company	Fidelity Group	Growth	0.85	0	69	22741.6	24394	31111	0.1275	0.85	0.2484	0.1275	1.2259
Vanguard Windsor II	Vanguard Group	Grw & Inc	0.37	0	26	22428.6	25267	23653	0.0936	0.37	0.0936	0.0936	0.5572
Fidelity Blue Chip Growth	Fidelity Group	Growth	0.87	0	46	21958.6	26408	17771	0.0673	0.87	0.1656	0.0673	1.1029
Fidelity Equity-Income	Fidelity Group	Eq Inc	0.67	0	25	21831.5	21004	11435	0.0544	0.67	0.09	0.0544	0.8144
American Funds Fdmntl Invs A	American Funds Group	Grw & Inc	0.64	0.25	43	19099.6	20000	22124	0.1106	0.64	0.1548	0.1106	0.9054
Fidelity Spartan U.S. Eq Idx	Fidelity Group	Grw & Inc	0.17	0	12	16417.2	17000	364	0.0021	0.17	0.0432	0.0021	0.2153
Vanguard Windsor	Vanguard Group	Grw & Inc	0.31	0	41	16026.7	16803	13120	0.0781	0.31	0.1476	0.0781	0.5357
Putnam Voyager A	Putnam Funds	Growth	0.88	0.25	140	15952.5	21700	63075	0.2907	0.88	0.504	0.2907	1.6747
Vanguard Tot Stk Idx	Vanguard Group	Grw & Inc	0.2	0	7	15781.5	23341	1968	0.0084	0.2	0.0252	0.0084	0.2336
Fidelity Dividend Growth	Fidelity Group	Growth	0.74	0	86	15210.3	12368	16795	0.1358	0.74	0.3096	0.1358	1.1854
Janus Twenty	Janus	Growth	0.85	0	27	15082.3	20321	985	0.0048	0.85	0.0972	0.0048	0.9520
AXP New Dimensions A	American Express	Growth	1	0.25	29	12946.8	25000	14907	0.0596	1	0.1044	0.0596	1.1640
Fidelity	Fidelity Group	Grw & Inc	0.56	0	217	12452.3	15483	42389	0.2738	0.56	0.7812	0.2738	1.6150
Fidelity Equity-Income II	Fidelity Group	Eq Inc	0.63	0	151	12211.7	12983	32501	0.2503	0.63	0.5436	0.2503	1.4239
Hartford Advisers HLS IA	Hartford HLS Mutual	Growth	0.66	0	40	11838	13000	6880	0.0529	0.66	0.144	0.0529	0.8569
AIM Constellation A	AIM Family of Funds	Growth	1.08	0.3	88	10635.5	15007	23003	0.1533	1.08	0.3168	0.1533	1.5501
Putnam New Opportunities A	Putnam Funds	Agg Grw	0.89	0.25	68	10572	12891	18781	0.1457	0.89	0.2448	0.1457	1.2805
Davis NY Venture A	Davis Funds	Growth	0.89	0.23	15	10463.3	21459	14028	0.0654	0.89	0.054	0.0654	1.0094
Fidelity Low-Priced Stock	Fidelity Group	Small Comp	1	0	44	10453.9	7550	7004	0.0928	1	0.1584	0.0928	1.2512
Lord Abbett Affiliated A	Lord Abbett	Grw & Inc	0.79	0.35	52	9362.4	12300	26213	0.2131	0.79	0.1872	0.2131	1.1903
T. Rowe Price Equity-Inc	T. Rowe Price Funds	Eq Inc	0.78	0	22	9464.2	10157	7344	0.0723	0.78	0.0612	0.0723	0.9135
						703424.3				0.70467	0.20352	0.1010	1.0092

EXAMINING SOFT-DOLLAR PRACTICES

WEDNESDAY, MARCH 31, 2004

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10:00 a.m., in room SD–538, Dirksen Senate Office Building, Senator Richard C. Shelby (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN RICHARD C. SHELBY

Chairman SHELBY. The hearing will come to order.

This morning, the Committee will examine soft-dollar practices in the mutual fund industry. Following the SEC's elimination of fixed brokerage commission rates in 1976, Congress enacted Section 28(e) of the Exchange Act, creating a safe harbor for soft-dollar arrangements. As generally understood, soft-dollar practices consist of arrangements in which investment advisers pay commission to a broker-dealer and receive bundled services such as executions and research products. Section 28(e) allows a fund adviser to pay more than the lowest available commission rate on the basis of the brokerage or research services provided, so long as the payment is reasonable in terms of a value of these services. Since enactment of Section 28(e), soft dollars have become the primary currency by which fund managers obtain research and other services from broker-dealers.

Soft-dollar arrangements can benefit investors by increasing the availability of research for a fund adviser. Many contend, however, that these practices are inherently conflicted, nontransparent, and lead to higher commission costs. Some argue that soft dollars harm investors by creating incentives for fund advisers to overtrade accounts and generate soft-dollar credits that can be used to pay for conferences and other business expenses. Many believe that because soft dollars are paid from brokerage commissions and not from the fund manager's pocket, there is little incentive for managers to be price sensitive. Many also state that the cost of soft dollars are hidden from investors and that bundled commissions, for both execution and research, lead to higher costs for investors. This hearing will be an opportunity today for the Committee to examine these arguments and to gain greater understanding of how soft dollars are currently used by funds, broker-dealers, and third-party researchers.

During the course of our hearings, witnesses have offered a range of reform alternatives concerning soft dollars. The SEC has convened a task force to examine soft dollars, and I anticipate that

it will soon offer reform recommendations to better protect shareholders' interests. Some contend that Congress should not wait for the SEC's proposals, but should instead repeal Section 28(e) and ban soft dollars. Others contend that Congressional action is unnecessary because the SEC already has the necessary authority to implement reforms. For example, the SEC could tighten the definition of "research" and require broker-dealers and funds to unbundle commissions, assigning specific values to execution and research. As this Committee evaluates possible legislative reforms, it is critical that we understand the merits and implications of various reform alternatives and proposals.

This morning, we will hear from various experts on soft-dollar practices. With us we have Harold Bradley, Chief Investment Officer of Growth Equities for American Century Investments; Geoffrey Edelstein, Managing Director and Co-Founder of Westcap Investors, LLC; Howard Schilit, Founder and CEO of Center for Financial Research and Analysis; Benn Steil, André Meyer Senior Fellow in International Economics at the Council on Foreign Relations; Grady Thomas, President of The Interstate Group; and Joseph Velli, Senior Executive Vice President of the Bank of New York.

I thank all of you for appearing here today.

Senator Allard.

STATEMENT OF SENATOR WAYNE ALLARD

Senator ALLARD. Mr. Chairman, I have a statement, and in order to expedite the hearing, I will just submit my comments for the record.

Chairman SHELBY. That will be made part of the record in its entirety.

Senator ALLARD. I would like to welcome the panel and look forward to hearing their comments this morning.

Chairman SHELBY. Senator Enzi.

STATEMENT OF SENATOR MICHAEL B. ENZI

Senator ENZI. Thank you, Mr. Chairman. I appreciate your holding this session, and I would ask that my complete statement be a part of the record.

Chairman SHELBY. Without objection, it will be made part of the record in its entirety.

Senator ENZI. Some have called for a complete ban on the soft-dollar arrangements and for 12b–1 fees. Previously, we have heard from witnesses before this Committee that there may be unintended consequences if a complete ban were implemented. One of the unintended consequences may be that mutual funds may be disinclined to use the independent third-party research if the mutual funds are required to pay for the research as an outright expense rather than being able to use the soft-dollar fees.

It is extremely troubling to me, as the global settlement between certain Wall Street firms and the SEC and State security regulators made independent research a key element of the agreement. I do think that we need to fully understand why these independent research firms would be placed at a disadvantage and what can be done so that they are not disproportionately affected by any proposed changes to the way the industry operates. I am very inter-

ested in hearing from the witnesses today on their views on how we can maintain the vital source of independent research.

In addition, I would like to know if investors would benefit from greater transparency on the payment and use of these funds and whether there should be greater accountability by mutual funds and the broker-dealer community on these monies.

Thank you, again, Mr. Chairman, for holding these two hearings today.

Chairman SHELBY. Mr. Bradley, we will start with you. All of your written testimony which we have will be made part of the Banking Committee's hearing record without objection. And if you would sum up your comments briefly. We are interested in finding out how the mutual fund business works, all aspects, and that is why we have had so many of these hearings because this is too important to rush to judgment on.

Thank you, Mr. Bradley. We will start with you.

STATEMENT OF HAROLD BRADLEY CHIEF INVESTMENT OFFICER, GROWTH EQUITIES AMERICAN CENTURY INVESTMENTS

Mr. BRADLEY. Thank you, Chairman Shelby.

Members of the Committee, thanks for the invitation for coming here. This is complicated stuff. I brought along some pictures because I think it is sometimes easier to tell a story with pictures, and I will walk you through these ideas.

We think this is a major problem for our industry—soft dollars or the 28(e) safe harbor—and a problem that we have been trying to illuminate for more than 10 years. I do a lot of public speaking on this and presentations and writing. We believe investors are paying undisclosed fees through soft-dollar practices with a negative impact on investors that vastly exceeds any sum associated with the already identified trading scandals.

American Century manages $90 billion for 1.5 million investors and mutual funds in separate accounts. My views reflect 16 years as the head of trading, and as a portfolio manager and chief investment officer for several mutual funds owned by our retail fund investors. I understand the role of Wall Street research, including independent research, and investment banking research and how each affects investors.

Section 28(e) provides a safe harbor, as you have already summarized, Chairman Shelby. We pay for ancillary services with those extra commissions; and the average institutional commission rate today is synonymous with inflated brokerage commissions.

These excess commissions often go from the investor's pocket, through the fund adviser, to the broker and back into the adviser's pocket. In the construction business, this arrangement is called a kickback. In our business, curiously, it is called a safe harbor.

Chairman SHELBY. Explain how it makes these rounds.

Mr. BRADLEY. Well, I have a bill. For instance, last year a computer company came in to pitch some computer technology to us, a $2-million bill. If I paid them $3.2 million in commissions, I had no bill, but I got the technology installed. I send my commissions to the broker. Under 28(e), the broker then says, "Oh, you have a relationship here. You have paid me commissions for research. I

will pay your computer vendor for you." And so that money goes in that circuitous fashion. I will try and develop a theme a little bit. It has an awful nice impact on the profit margins of an investment adviser.

There have been repeated reform attempts, and I notice the GAO testimony said that the SEC has studied this. The regulators and Congress have studied this issue to death for at least 25 years. Ever since the safe harbor was created, people have worried what would happen, and we are now at the day of reckoning, where it is a major force in our business and, again, a growing problem.

If I could let you look at some of these charts, maybe it will lay out for you a little bit, too, how this food chain works.

Exhibit 1 is, "What Does 'Paying Up' Mean." I just have a simple bar graph. Last year, American Century did 55 percent of its business on execution-only venues. In other words, we paid for no research at all on these execution venues.

Mr. Chairman, do you see where I am here?

Chairman SHELBY. I understand you.

Mr. BRADLEY. That bar at the bottom is our effective execution-only rate, about .88 cents a share.

The other bar represents all of the other goodies, including valuable ideas in research, which are in that bar, that are paid with the extra. The bar goes up to what Greenwich reported last year as the average all-in commission rate, the bundled rate, in our business. In that are IPO allocations, normal and customary business expenses, fund expenses and then bundled research.

If you go to the next page—well, and actually I think where we need help is section 28(e), we do need to amend 28(e), at a minimum. And what we should do is preclude, from any broad definition of research the following: Computer hardware and software, publications including books, periodicals and newspapers, professional development seminar fees, exchange data for quotes and services.

For goodness sakes, if you pay a management fee, should the manager not be able to afford paying for his quotes from the New York Stock Exchange? How else can you manage money?

And then investors should not be able to use commissioners to pay for any service from third-party providers otherwise available for cash to the general public—the so-called pre-1986 standard.

The next graph gives you a little bit more perspective. In 1976, Congress acted on commissions because they were fixed, and there were lots of goodies changing hands under the table. What they did is said let us deregulate commissions. Well, what happened is commissions went to 5 cents a share and stayed there for 15 years. Because the goodies were under the table, volumes went up by 6 times. That is the solid bar. It shows the increase in trading volume in the New York Stock Exchange over that time. Effectively, you had a sixfold increase in trading volume, with commissions going down 15 percent. It seems kind of sticky to me, and I think there are significant economic benefits that have led to the dramatic increase in this business activity.

So we think that, to start: Remove the incentives. Prohibit fund advisers from taking into account sales of fund shares in the allocation of brokerage commissions. Direct the SEC to regulate invest-

ment bank activity, where excess commissions—and this gets back to some of the Spitzer findings—are used by the industry's largest and most dominant players to secure access to the hottest deals. This pay-to-play practice must be transparent. Require the SEC to gather and publish an industry-wide average execution-only rate from all registered broker-dealers. This would become a benchmark for the industry where fund advisers would then have to justify anything above that rate, in terms of value of research and services to fund directors and investors. Frankly, there should be a companion hard-dollar disclosure of the costs for such services as well.

The Financial Services Authority is working on this in London right now, and I have some stuff off their website I would like to enter.

Chairman SHELBY. We will make that part of the record.

Mr. BRADLEY. Thank you.

Exhibit 3, I have a very simplistic illustration of the impact of soft dollars on fund company profitability, but it is real. I took the numbers that are averages we have on how costs are attributed within the mutual fund business to an adviser. And what we see is that high cents per share commission rates can really positively influence operating profitability.

According to Greenwich Research, soft-dollar usage increased significantly during the bear market. This outcome should have been anticipated. Income for fund advisers is driven by assets under management. As assets fell, revenue for the asset managers fell. Faced with the choice to cut costs to preserve profit margins or use more trading commissions to pay the bills, many chose the latter. It is a staggering fee that is levied on investors without their knowledge, and we need more complete soft-dollar recordkeeping and periodic review, at a minimum, by fund boards and the SEC.

Chairman SHELBY. Where has the SEC been on all of this?

Mr. BRADLEY. The SEC, frankly, has studied this a lot, and they had recommendations after their sweep in 1998. The GAO has told you the same thing, and they have not acted on their own recommendations. Now, they have been a little busy lately, but I think that is why they need the help. Many people blame the broad language in 28(e) for the reason they cannot act. And the interpretative release that they put out, without rulemaking, in 1985 is what opened this floodgate.

Are we a lone voice in the wilderness on this? For about 10 years, we felt that way. Right now, the industry is running fast and hard from this problem, and I have not met anybody who is willing to stand up and defend what has been going on here.

The GAO and large and small practitioners have appeared in front of you. Thirty-seven percent of leading traders—these were head traders from major organizations gathered at a broker conference last year—reported that directed orders and soft-dollar obligations represented the biggest impediment to best execution.* The professionals know this is a big problem. Most of them do not have the courage to solve it. There is too much profit in it.

How about unbundling? I know there has been some talk here and in the media about unbundling. Is it desirable? Nobody in our

* Held in Banking Committee files.

business can agree on a majority of anything. According to Benn Steil's work, 51 percent think that unbundling is desirable.* Most do not think it is feasible. Again, they do not have the courage because of the distribution practices and the extra profit incentive advisers enjoy in the way the business is currently structured.

At Exhibit 4, I have attached a little bit more information to quantify the extent of this problem. I called a broker and said, "If I was going to pay soft, what can I pay for?" He sent me a list, in 1988—I have been doing this for a long time you can see now—in 1988, when I first wrote in my Market 2000 piece, 264 vendors were on that list; in 1994, 573 vendors. Today, more than 1,200 companies meet the definition of research as advisers have defined it. I will tell you what I can pay for—not I. My counsel has told me not to say "I." What those in the business might pay for. We chose not to do this.

Ernst & Young is on the list; Buck Consulting, a compensation consultant; New York Stock Exchange Quote Fees; Nasdaq; the Wharton School for Executive Education; *The Wall Street Journal*; Oracle and Dell. Stuff people have in their homes are getting paid in the business with commissions.

Finally, when I am really tired at the end of the day, this is one I found really interesting on this soft-dollar list, the Standard Club of Chicago. Apparently, tired portfolio managers go into the trading room and say, "Hey, can I ship a little dollars here because they are on the soft-dollar list," probably for seminars. But, again, I think this speaks to the problem we have here that demands definition and constriction. And I think that this problem, in some of the data I have seen, can represent as much as a $6-billion-fee levy on investors that needs to be fixed.

I thank you for the opportunity to comment on these issues.

Chairman SHELBY. Mr. Edelstein.

STATEMENT OF GEOFFREY I. EDELSTEIN, CFA, CIC MANAGING DIRECTOR AND CO-FOUNDER WESTCAP INVESTORS, LLC, ON BEHALF OF THE INVESTMENT COUNCIL ASSOCIATION OF AMERICA

Mr. EDELSTEIN. Chairman Shelby and Members of the Committee, thank you for the opportunity to appear here today.

I am a Managing Director and Co-Founder of Westcap Investors in Los Angeles. Westcap is registered as an investment adviser with the SEC. Our firm was founded in 1992 with four employees and no assets under management, and today we employ 43 people and manage about $2.8 billion in growth stocks and fixed income. I am pleased to bring to this panel the unique perspective of a smaller money manager. The Investment Council Association of America represents Westcap and SEC-registered investment advisory firms. I am offering my testimony today on behalf of the ICAA.

Westcap is a research-intensive firm. Our team of 13 investment professionals conducts extensive research on the investment environment and individual companies. This internal research is augmented by external research provided by brokerage firms, com-

* Held in Banking Committee files.

monly referred to proprietary research. In addition, we use external research from other third-party providers.

Examples of proprietary research services that we use include not only written research reports, but also, more importantly, to our firm access to economists, strategists, analysts, and company management. The research received from third parties includes the same range of services provided by those full-service brokers, as well as access to information sources and analytical systems. All of this information is considered, along with our internal research, in making investment decisions on behalf of our clients.

The research services that we purchase, whether proprietary or third party, are essential to our research process. The ability to use soft dollars to pay for research was crucial in the start-up phase of our firm, and it continues to give us access to information that otherwise would be unattainable. This allows us to provide services on par with firms of far greater size than ours.

Small- and medium-size firms are important participants in the capital markets. They fill a wide variety of market needs in terms of asset classes, level of service, size of clients, and regional coverage. Smaller managers can be more nimble in their management and very successful. For example, a study of the rate of return over the past 5 years for large-cap growth separate account managers shows that 7 of the top 10 performing managers have less than $2 billion under management. Clearly, smaller firms can provide investors an attractive alternative to larger firms.

Following are the three major points described in greater detail in my written statement:

First, investment advisers are fiduciaries who have an obligation to seek best execution in connection with client transactions and to disclose potential conflicts of interest to clients. Client brokerage is an asset of the client, not of the adviser, and thus there is a potential conflict where an adviser uses commissions to pay for research. Accordingly, we support full and appropriate disclosure of soft-dollar practices by all investment advisers. Consistent with the basic approach of U.S. securities laws and market principles, we strongly believe the SEC should ensure that there is adequate disclosure regarding soft-dollar practices, combined with appropriate inspection and enforcement of regulations governing these practices.

Second, we support the SEC's current initiative to examine soft-dollar practices. Specifically, we urge the SEC to propose rules ensuring that required disclosures related to soft-dollar arrangements are adequate and appropriate, requiring enhanced recordkeeping to demonstrate compliance, and clarifying the current definition of research. The consequences of abolishing soft dollars, an outcome that would require Congressional action, will adversely affect smaller investment advisory firms, reducing the services they provide, and encroaching on their ability to compete with larger firms. It will create barriers to entry for new investment advisory firms, further reducing competition, and it will diminish the availability of third-party research.

Finally, we strongly oppose the recommendation that the SEC should eliminate the use of soft dollars for third-party research. We believe this approach would harm investors and diminish the availability of quality research. It would result in an unjustifiable,

unlevel playing field, providing a regulatory-driven advantage for full-service brokerage firms, and a disadvantage to third-party research providers. Eliminating soft dollars for third-party research would also result in less transparency to investors, regulators, and market participants.

Thank you again for the opportunity to testify today. I commend the Committee for its deliberate and thorough approach in considering these and other important issues, and I look forward to your questions.

Chairman SHELBY. Mr. Schilit, go ahead, sir.

STATEMENT OF HOWARD M. SCHILIT, PHD, CPA CHAIRMAN AND CHIEF EXECUTIVE OFFICER CENTER FOR FINANCIAL RESEARCH & ANALYSIS (CFRA)

Mr. SCHILIT. Thank you, Chairman Shelby and the rest of this distinguished panel.

I am Howard Schilit, the Founder of a large independent research organization called the Center for Financial Research and Analysis and also author of the book called, "Financial Shenanigans: How to Detect Accounting Gimmicks and Fraud in Financial Reports." Our organization serves as an independent watch dog organization for investors, warning them about unusual accounting practices. Two years ago, I testified before the Governmental Affairs Committee at the height of the Enron hearings, and we witnessed some very sad events during that period, and I hope and pray we do not have a repeat of that.

Independent research organizations, in general, perform an important watch dog role for investors. As we all know, our Founding Fathers had the wisdom to devise a system of checks and balances to not allow a single branch of Government to exert undue power. In much the same way, the independent research industry provides checks over potentially biased and misleading information distributed by public companies and their sponsors at investment banking brokerage firms.

Independent research organizations typically are paid by third-party brokers that use soft-dollar commissions. A ban on soft-dollar commissions would have a devastating impact on independent research firms and indirectly hurt investors. I urge this Committee to search for other solutions and leave soft-dollar payments intact.

Historically, when investment managers trade stock, they have had to purchase a bundled package of services from one source—full-service brokerage firms. All research, trading, and other brokerage services came from this one source. Within the last generation, competition has emerged as small boutique brokerage firms enter the market, driving down commission rates. In order to truly compete with full-service brokerage firms, the boutiques needed to bundle some value-added services. Since customers wanted research, the boutiques outsourced these products by partnering with value-added independent research organizations.

Investment managers loved having new trading partners and new research sources. In contrast, traditional, proprietary full-service brokerage firms were not pleased at all with competition emerging on two fronts: brokerage and research. In the old days, proprietary brokerage firms were the only game in town. They had

a monopoly on trading and research, and investors paid exorbitant commissions for research of questionable value.

Fortunately, for investors, the proprietary brokerage monopoly has been threatened. Today, competition is fierce for trading commissions driving trading costs lower for investors, and fierce competition exists on the research front as well, with over 300 entrepreneurial independent research firms pushed to produce the most value-added research at the best price. Investors never had it so good, with commission costs dropping and high-quality, independent research widely available.

Unfortunately, for investors, the proprietary brokerage firms are fighting hard to regain their monopoly in trading and research. They are pushing for a ban on soft-dollar trading, the commissions typically paid to smaller brokerage firms and later directed to independent research organizations. The single act of banning soft dollars would irreparably hurt competition from boutique brokers and independent research organizations.

My first recommendation is to retain the current soft-dollar mechanism to provide flexible payment options for purchasing independent research. Now, make no mistake, there are serious issues and problems that need to be addressed so that brokerage commissions charged are fair and reported in a transparent fashion and that investment managers always act in the best interest of the investing public.

I have a few fundamental questions before I give my specific recommendations:

What is the appropriate currency, brokerage commissions, or cash to be used for investment research? Is it inherently wrong for investment managers to use commissions as the currency to pay for research or consulting services? I think not since, for over 200 years, most investors have used trading commissions as the sole currency for such services.

If, however, you disagree and believe that a new currency should be used, that is, cash only for research, that would be agreeable, provided all research purchased by investment managers is paid for with cash. Thus, if commissions were banned as a currency to pay for third-party independent research, then I would urge you to establish a total ban on using commissions for any research from any source.

Specifically, if an investment manager purchased research from my investment organization and must pay cash, then, in all fairness, research that is acquired from Merrill Lynch, Goldman Sachs, Morgan Stanley should also require a cash payment as well. I would have no objection to creating a meritocracy that allows all research providers to compete on the same playing field.

So, Recommendation No. 2, assuming there is little interest in a cash-only approach, commissions should be in the currency of or the currency for paying for research should remain commissions, and no distinction should be made between research that is provided from proprietary brokerage firms and from third-party firms.

Some specific recommendations and issues are: Bundling execution costs, where there is no differentiation between the execution and the other services; failure of mutual fund companies to include the nonexecution portion of the commission in their expense ratio;

and inflated brokerage commissions and inadequate disclosure of that portion of the brokerage commission directed to third parties. I have a recommendation to solve each one of these.

Recommendation No. 3, all brokerage organizations must unbundle execution from nonexecution costs and disclose this information to investment companies. Since nonexecution brokerage commissions are identical at all firms, regulations should treat them as such. Requiring the unbundling of brokerage commissions and showing the trade execution costs and other services separately can easily solve most problems that this Committee is addressing.

Full-service brokerage firms typically charge 5 cents per share to trade, down from about 8 cents a number of years ago. Included is approximately 2 cents for execution, and the remaining 3 cents for nonexecution costs, including such things as research. Brokerage firms have not been required to disclose to investors and other stakeholders how the 3-cents-per-share is spent and consequently fail to report this information. In many cases, the 3 cents supports in-house research and operations at proprietary brokerage firms. In contrast at soft-dollar brokerage firms, the 3 cents is paid out to third-party research organizations. In essence, the commissions that are paid, whether at a proprietary brokerage firm or a third-party brokerage firm, is essentially the same. Whereas, the proprietary brokerage firm keeps all 5 cents for their in-house execution and other services, and the boutique brokerage firm outsources and pays a part of that 5 cents to research organizations, such as myself. In essence, the customer is not being ripped off or not paying more by going to a third-party firm.

Recommendation No. 4, nonexecution costs should be included in the expense ratio that mutual fund companies disclose. I think research is a part of the cost of the mutual fund. A big mutual fund, as American Century, has an army of in-house analysts. That is included in their expense, and if they decide to outsource some of the research to third parties, whether it is a Merrill Lynch or whether it is a CFRA, those are the same type of research expenses that should be included in the expense ratio by requiring brokerage firms to unbundle the total commission. And we know how much is execution and how much is research. That problem is solved. We simply need regulation that requires mutual fund companies to include research from whatever source in the ratio.

Recommendation No. 5, regulators and accountants should audit the records of both brokerage organizations and investment managers to ascertain proper accounting and disclosure of nonexecution costs and the expense ratio. So, once we have an à la carte menu of how much is the nonexecution cost, how much is research, then regulators could require including that information in the expense ratio and it is auditable.

And my last recommendation, No. 6, is severe penalties should be meted out to organizations that fail to properly account for nonexecution costs.

So, in summation, I believe that the world we are looking for, lower brokerage commissions, giving investment managers the flexibility to purchase on an à la carte menu where they trade, where they are going to purchase research, will drive down the commission costs and will allow the investment manager to pur-

chase research from wherever they believe the greatest value is going to be, and with the unbundling of the total brokerage commission, then we are in a position to know whether people are cheating. And we are able to say to investment managers, you must include the total research costs in your expense ratios to shareholders.

I thank you all for this opportunity.

Chairman SHELBY. Mr. Steil.

STATEMENT OF BENN STEIL, PHD
ANDRÉ MEYER SENIOR FELLOW
IN INTERNATIONAL ECONOMICS
COUNCIL ON FOREIGN RELATIONS

Mr. STEIL. Thank you, Mr. Chairman, and thank you, Members of the Committee, for the opportunity to testify before you this morning.

The central question before us this morning is why fund managers should choose to buy research, computer systems, and other support services as a bundle, indirectly through trading commissions, rather than directly by agreeing a price for each product with the research purveyors, with the computer system purveyors, et cetera, and writing checks to each of them. After all, that is how normal businesses pay for their consulting, their computers, et cetera. That is how you and I pay for such services. We do not, for example, pay for a computer by agreeing to buy $3,000 worth of telephone calls from a telephone company.

The answer to this question, Mr. Chairman, is very simple. The fund managers are trying to finance as much of their operating costs as possible using their client's assets rather than their own. And the only way that they can do this legally, other than through the management fee, is through trading commissions. It would, for example, be illegal for them to buy computers through bills paid to a telephone company out of their clients' assets, but it is legal for them to do so through brokerage commissions. This is the significance of the Section 28(e) loophole in the Securities Exchange Act which, in my view, has given rise to a vast industry-wide kickback scheme through which fund managers use institutional brokers to transfer fundholder assets to themselves in a manner totally invisible to the fundholders.

The mutual funds will tell you, Mr. Chairman—indeed, legally, they must tell you—that they use soft dollars to buy research. This is true, but also very misleading. As Mark Twain observed, Mr. Chairman, almost all lies are acts and speech has no part in them.

Let me illustrate. As you will see from the attached Figure 1, attached to my testimony, mutual funds actually pay trading commissions to brokerage firms using their clients' money to buy such diverse items as newspapers, magazines, online services, conference registrations, accounting services, proxy services, office administration, computers, monitors, printers, modems, cables, software, network support, and maintenance agreements. And in one of the ultimate ironies, Mr. Chairman, fund managers even pay inflated trading commissions to brokers in return for third-party trading cost measurement services, which invariably tell them that their brokers cost too much.

Now, how significant is this problem? Let me provide just a few examples for you.

As you will see in the attached Figure 2, the average institutional broker kicks back $1 in products and services to the fund manager for every $1.60 it receives in trading commissions. That is, most of the standard institutional trading commission represents payment for items that have nothing to do with trading. As you will see in Figure 3, the percentage of institutional trading commissions allocated specifically to pay for "research," broadly defined, rather than good trade executions, actually rose from 29 percent in 2001 to 39 percent in 2003. That is, the problem is getting worse.

Figure 4 will show you that the average fund manager cannot possibly be seeking best execution for the client, as the trading desks, according to the funds themselves, only control between 21 and 29 percent of the commission payments. The bulk of these payments are determined in advance by others who never actually initiate trades themselves.

Now, how much does this practice of soft-dollar trading actually cost investors? I would remind the Committee that in the recent fund timing investigations, it was widely suggested that the cost to investors of this practice was about 5 basis points. In my attached paper on "The Economics of Soft-Dollar Trading," I estimate that the true effective management fee that a fundholder pays is about 70—seven-zero—basis points higher than the headline fee which the fundholder sees in the prospectus. This 70-basis-point premium is accounted for by bad trading: commissions which are about 2.5 times higher than they would be if the fund manager were seeking best execution, even after stripping out the value of the kickback services—that is, I am assuming that the kickback services directly assist the investor—and implicit—or market impact—costs about 3 times higher.

Now, if the Committee accepts that soft-dollar trading is indeed a problem, how then should this problem be addressed? There are three basic approaches:

The first approach is to require increased disclosure of trading costs to fundholders. More information is always preferable to less, in my view, but this is not——

Chairman SHELBY. How would you do that?

Mr. STEIL. A very good question. Most people who support this support doing it through the expense ratio. Mr. Pozen, and others, have presented you the complications in doing that. My feeling is that it also would leave out the most significant portion of trading costs, which is totally invisible. This is the market impact or implicit cost. This measures the cost of bad trading, above and beyond the trading commission.

For example, a lot of so-called research firms have brokerage arms attached to them not because they are particularly good at executing trades, but because that is the only way that they can get paid, using the fund manager's clients' assets, rather than using the fund manager's assets. So these firms are not set up specifically because they trade well, but because they want to receive these soft-commission payments.

In my view, it should be through the management fee, and I will explain in my last point how I think that could be done.

Since the largest component of trading costs—so-called implicit costs—is not actually captured in the visible commission fees at all, we must ultimately look for a solution that encourages fund managers to trade as efficiently as possible, not just in the interests of their client, but in their own self-interest.

More fundamentally, if the practice does truly represent an abuse of fundholder assets, surely, the remedy must be more robust than just disclosure. After all, we do not merely regulate fiduciary abuses by obliging fiduciaries to publish a costed inventory of client property improperly used.

Now, a second approach is to eliminate the 28(e) loophole entirely. In other words, fund managers would only be allowed to use trading commissions to pay for trading. This would be a big step forward, although I do suspect that funds will try to continue to pay inflated trading commissions in return for kickback services that will simply be less visible to regulators. There is no doubt, for example, that the industry pushed a lot of practice underground after the SEC sweep in 1997.

Now, a third approach would be to oblige fund managers to pay trading commissions out of their own assets—as recommended in the March 2001 Myners Report prepared for the Treasury of the United Kingdom. This would dramatically realign fund managers' interests with those of their clients. They would immediately unbundle commissions and seek best execution because it would be in their self-interest, as well as the interest of their clients. It would, in fact, lead to a dramatic improvement in U.S. market structure, with an expansion of low-cost direct electronic trading at the expense of brokers whose only value added is in facilitating the soft-dollar kickback system.

As I show in my paper on "The Economics of Soft-Dollar Trading," a typical fund management firm could cover the cost of bearing trading commissions by raising its management fee by about 18 basis points, and this would still leave the fundholder better off by about 50—five-zero—basis points.

Chairman SHELBY. How would that translate into real savings dollars—55 basis points is——

Mr. STEIL. Sure. Well, take a fund manager who is charging a 1 percent management fee.

Chairman SHELBY. So half of it.

Mr. STEIL. Right now, that fund manager is really charging the client 1.7 percent.

Chairman SHELBY. Okay.

Mr. STEIL. The client just does not know it. Now, if this fund manager were to move to hard-dollar trading, that fund manager would suddenly become terribly concerned with the cost of trading and would redirect his trading from soft-dollar brokers to the cheapest possible trading vehicles available. Now, that would be a cost to the fund management firm if they had to pay those trading commissions themselves. So, I calculate, if they wanted to recoup the entire cost, they could raise their fee by 18 basis points. So, now, the management fee would be 1.18 percent. But that would still leave the client better off by 52 basis points. Because, if you

remember, the effective management fee was 1.7. Both the fundholder and the fund manager would be better off.

The only losers in this unbundling process, over the long run, are the brokers who earn their living facilitating soft-dollar kickbacks. American investors, in my view, would be far better off if these brokers found another way to employ their capital.

I thank you again for the opportunity to testify this morning, and I look forward to assisting your deliberations.

Chairman SHELBY. Thank you.

Mr. Thomas.

STATEMENT OF GRADY G. THOMAS, JR.
PRESIDENT, THE INTERSTATE GROUP
DIVISION OF MORGAN KEEGAN & COMPANY, INC.

Mr. THOMAS. Thank you, Chairman Shelby, and Members of the Committee.

My name is Grady Thomas. I have been in the securities business for 40 years, and in 1986 became the President of the Interstate Group, today a Division of Morgan Keegan & Co., Inc. I have been active in the securities industry. I was on the board of directors of the Boston Stock Exchange for 8 years, served as Chairman and President of the NOIP, the National Organization of Investment Professionals, was Chairman of the NASD District 7. I am currently Chairman of the SIA Institutional Brokerage Committee.

Interstate Group has provided independent research for commission dollars to investment advisers and mutual funds since 1975. During the past 30 years, I have seen innovative research flourish and institutional commission rates fall from a high of 82 cents a 100 to approximately 5 cents a share today. For example, in 1975, if a manager put an order in to buy a thousand shares of $100 stock, the commission was $750. Today, that commission would be roughly $50. In 1975, there were 400 mutual funds, 4,000 investment advisers, and hedge funds were practically unheard of, only around 200.

So where are we today? Today, there is 8,000-plus mutual funds, 7,000 investment advisers and 6,000 hedge funds. Mutual funds alone manage $7.5 trillion in assets. The result is a wide selection of fund opportunities for an individual investor and the need for informative, readily available research for the investment manager who must excel in a highly competitive marketplace.

Over the years, I have seen the transparency of independent research arrangements improved to the point where investment managers involved in these transactions receive monthly statements detailing the type of research provided, its cash value, and the total commissions used to pay for that research. This has all been to the advantage of security markets and investors.

The driving force behind these beneficial developments has been Section 28(e) safe harbor adopted by Congress in 1975. I was there in 1975 when 28(e) was approved, and I believe that Congress and the SEC got it right. Research and execution of services provided by broker-dealers to investment managers add value to investment managers' accounts.

In its consideration of 28(e), Congress recognized that without access to research through portfolio commissions, small investment

managers would have to charge higher advisory fees. The adoption of 28(e) has allowed start-up and smaller investment managers to compete with large advisory firms on a more level playing field.

In 1986, the SEC revisited 28(e). Up to that point, research was delivered basically by the U.S. Post Office in the form of written reports, ink on paper. Managers had to shuffle through tall stacks of research reports to make their investment decisions. Locating that information was a tedious task at best. Then, the method of delivery changed. The fax machine and FedEx came along speeding delivery of reports. Meanwhile, technology was making huge advances, moving into the computer era in the 1980's.

In 1986, the SEC broadened the scope of 28(e) to accept electronic research capabilities. In my opinion, we would not have the incredible pool of research we have available today without the door that was opened in the 1986 release. Systems have developed which can take the balance sheets of 17,000 companies, and using hundreds of different parameters, can crunch those numbers in literally seconds—seconds. That would have been an impossible research task just a few years ago. Today, with the electronic boom, almost all research is provided through e-mail, through the Internet, T–1 lines, so delivery is instantaneous. Portfolio managers have a wealth of creative research, sophisticated systems available to assist them in the investment decisionmaking process.

The safe harbor has allowed broker-dealers, specializing not only in execution, but also the provision of independent research, to compete more equally with large Wall Street firms. The result has been lower execution costs and more competition.

In closing, I heard testimony last week in this room, which is often repeated in the press, that commission dollars are used to pay for such items as rent. In my 30 years providing independent research, I have never been asked to provide an item such as rent in a 28(e) arrangement. This is not research, and it is not covered by Section 28(e) safe harbor. I think that the SEC studies and examinations bear this out.

The SEC did an extensive sweep in 1997 of 75 broker-dealers, 280 investment advisers, and investment companies. We were part of that sweep, and we received a clean letter from the SEC. Quoting from the SEC Inspection Report, issued September 22, 1998, "We did not observe any instances in which fund commissions were used to purchase non-research items which did not directly benefit the funds themselves."

In Section VIII of the Inspection Report, the SEC staff made a number of recommendations pertaining to the provision of independent research for portfolio commissions. I encourage the SEC to give further consideration to these recommendations.

Congress and the SEC showed foresight when they adopted Section 28(e) in 1975 and broadened the scope in 1986. The results have been an increase in competition and in the availability of excellent research, both of which, bottom line, benefit all investors. In a nutshell, 28(e) is the gas that drives the research engine.

Thank you for allowing me to appear before you today, and I would be glad to answer all of your questions.

Chairman SHELBY. Mr. Velli.

STATEMENT OF JOSEPH M. VELLI
SENIOR EXECUTIVE VICE PRESIDENT
THE BANK OF NEW YORK

Mr. VELLI. Chairman Shelby and Members of the Committee, I am Joseph Velli of The Bank of New York. Thank you for allowing me to testify today.

We appreciate the Committee's efforts to examine issues concerning mutual fund practices. We would also like to applaud the SEC for proposing new rules to ensure that investors are given a fair shake. The Bank of New York is the oldest bank in the United States, founded by Alexander Hamilton. Today, The Bank of New York is a global leader in securities services. In fact, today, we safe-keep over $8 trillion in investor assets. BNY Securities Group houses the bank's agency brokerage and clearing businesses. We believe BNY Securities Group is the largest agency brokerage firm in the world.

Securities-related research is, and always has been, an integrated part of the brokerage business. Soft-dollar commissions are the method of paying for research, whether the research is produced by a full-service investment banking firm or by an independent research firm. Even though the same term is used, the level of disclosure is very different. Full-service firms bundle numerous services, including research, into one commission rate. Agency brokers fully disclose the cost of independent research and of execution.

It is important to note that not one of the recent scandals has involved soft dollars under either the full-service or agency models. Yet, these practices are under fire. Part of the perceived problem is in the name "soft dollars." I cannot think of a more misleading name. In describing what we do as an agency broker, we prefer to use the term "independent research commissions." All of the noise around whether soft dollars are good or bad has had a chilling effect on the market. This has resulted in independent research being scaled back, which is unhealthy.

Without dynamic research, advisers cannot meet their obligations to investors. We believe that the appropriate action would be for the SEC to reassure the markets and enhance access to independent research by clarifying its guidelines under Section 28(e). As mentioned earlier, SEC Chairman Donaldson has created a task force to review this subject and additional guidance is likely.

Broker-dealers that offer independent research have made a business of disclosure and commission management. Our clients expect us to account for every penny of their clients' commissions, and we do. Like many other firms, and as Mr. Thomas mentioned, we give our clients detailed statements reporting their trading activity, the independent research provided, and their separate costs.

We see four intrinsic values in independent research: One, it is free of conflicts, which is very important; two, it stands on its own merits. It either performs well or it is no longer selected; three, it is serious, innovative, and often very different from Wall Street research; and four, it serves the public interest. Long before regulators reacted, various independent researchers uncovered the frauds of Enron and WorldCom. In settling the case of tainted research last year, the regulators further validated the importance of

independent research. We do not need less independent research. We need more.

It is important that Congress not place an unfair burden on independent research as compared to proprietary research, a result that is at odds with the principles of the global settlement.

Research has always been paid for with commissions and is a natural alignment of the ideas generated and compensation paid for those ideas. Increased disclosure will better allow the asset manager to judge the value of the research and make the asset manager and broker more accountable to the underlying investor.

Some assert that mutual fund managers engage in this practice for their own benefit, without the investor or the fund board's knowledge. The way to solve this problem is through disclosure and responsible fund governance.

Many have asked, "Why not cash?" There would be considerable negative consequences to banning the use of commissions to pay for research. Among the losers would be investors, independent research firms, small mutual funds, agency brokers, and funds reliant on sophisticated analytics. Such a radical change would strike a hard blow to independent research just as it is coming into full bloom, and would also lead to further reduction of proprietary research. This cannot be good for investors.

Agency brokers and independent researchers, whose fees are transparent, already compete on an uneven playing field. Allowing advisers to use commissions to pay for research from full-service firms, but not for independent research, would simply be unfair and create a competitive disadvantage, the worst-possible outcome.

Most mutual funds have limited internal research staffs. They rely on independent and proprietary research. Some of the larger funds employ hundreds of their own researchers, yet some of the highest returns are generated by smaller funds.

According to a 1998 SEC report, the smallest advisory firms used over half of their commissions for independent research, while the largest advisory firms used, on average, 8.3 percent. In other words, independent research provides essential support to smaller funds. Abolishing research commissions would extend the dominance of the large mutual fund complexes, limiting competition, reducing choice, and hurting small mutual funds. Since the costs of independent research are disclosed, they are, and can be, audited.

Lastly, we believe that commissions used to pay for research should be accounted for. However, we do not support full unbundling of commissions by the full-service firms, even though we as, an agency broker, might benefit. Full unbundling would be highly disruptive to the markets, difficult to account for and accomplish, and would lead to a drastic reduction in research.

In conclusion, soft-dollar practices benefit investors. So what is the problem? Investors should have more information about how investment advisers are using their commission dollars. Better disclosure will help restore investor trust and will make all market participants more accountable.

We agree with the SIA, which supports the safe harbor for research created by Section 28(e), that the SEC mandate reasonable additional disclosure. We are confident that the SEC can manage this responsibility. If we are to ban anything, let us ban the term

"soft dollars." Let us call them what they are—research commissions—and encourage the greater use of independent research.

Thank you for this opportunity.

Chairman SHELBY. Thank you.

Senator Allard.

COMMENTS OF SENATOR WAYNE ALLARD

Senator ALLARD. First question, I have been particularly interested in the role that disclosure plays as a it relates to appropriateness to the investor both—in the amount of disclosure provided and the location in which that information is provided.

I understand that current law requires that investment advisers disclose the mutual fund soft-dollar policies and procedures "in law," as necessary or appropriate in the public interest or for the protection of the investors.

I would be interested to hear from any of the witnesses regarding, first, what information on soft dollars is specifically required to be disclosed by law and, second, where that information is located or provided to the investor.

Mr. Bailey.

Mr. BRADLEY. May I, Senator Allard?

Senator ALLARD. Yes.

Mr. BRADLEY. Currently, there is broad and generic disclosure in Form ADV which investors must ask to receive as an additional or supplemental piece of information.

My problem with that particular disclosure, it is a very broad, as is 28(e), it says, "Would you categorize who provides research and services," not what they are, not what the hard-dollar equivalent amount might be, and very, very little else. So it just becomes kind of a line-by-line summary, and that is really the only disclosure there is.

When we talked to our accountants about this a year ago, I asked why this is not treated as either an income or expense item on a fund's income statement. And according to our accountants—fund accountants and auditors—they disclosed to us that because these are not written agreements, in fact, 28(e) is an agreement between the broker and Oracle or the broker and Dell, not between me and Dell or Oracle. So that, while I get a record back, there is no requirement that I provide that recordkeeping to anybody else. Without a specific record of the cost of the service, accountants say it falls outside of GAAP rules—if such costs were captured and reported, funds may be required to report the use of commissions as income and subject to taxation.

In fact, the SEC, in that same study that was quoted, also said that the recordkeeping and ability to get at the records was a key problem, and that was some of the recommendations they had asked for.

Senator ALLARD. How do they deal with multiple transactions? How were those charges allocated out? If you had a number of clients invest, and you use that research data, I would not expect, if you are making the same investments, that you keep ordering new research. Is that allocated out to the various accounts or is that ignored? How is that handled?

Mr. BRADLEY. Well, right now my understanding is—I am not a lawyer and I am not in the business. I am on the buy side. We are called the buy side because we buy these services—what typically happens is they are not broken out by fund, but in a broad aggregate in the SAI, I think which is fund specific. But, again, I am not in the lawyer's office. I am a practitioner. There is an attempt, but they are not broken out on an allocated cost-to-fund basis.

Mr. VELLI. Senator, I think you hit the button right on the head as far as a weakness as we see it. We believe that more disclosure should be given to the investor, and we have been very strong advocates of creating various buckets for commissions as to how an asset manager would record and disclose these, how they are using their commissions: Basically, execution-only, bundled commissions for proprietary research, and also how much of the commission dollars are going to independent research.

We believe that if you take that type of approach, over time, asset managers will increase their use of independent research and investors will also demand it and be able to monitor the different funds and how they are spending their commission dollars.

Mr. EDELSTEIN. Currently, our disclosure is Form ADV. We manage money for institutions, individuals, and also sub-advise to mutual funds. And all of those types of clients ask us for additional disclosure of what we buy in detail, what their commission levels were, a description of not only what we are buying, but also how it is used in the decisionmaking process.

I think that process would enhance more conservative practices in this area. It certainly, you know, bears upon our decisionmaking when we utilize commissions.

Additionally, we do not have the ability to buy anything we want. As a smaller firm, our budget is quite limited, so we are rationing what we are buying. There are a lot of things that we buy with hard dollars that other firms are able to buy with soft dollars.

Mr. THOMAS. Senator, all our clients receive detailed monthly statements, including the breakdown of every trade, every invoice, every service we provide. That information is then checked, I am sure, by the manager's internal auditors. And to my knowledge, it is referred to their fund board of directors, so they see that information also.

Senator ALLARD. Mr. Steil.

Mr. STEIL. Two very brief points. First, with regard to the track record on disclosure, the SEC in its 1997 sweep, found a number of interesting items. I will just give you a few of them.

Half of all investment advisers failed to disclose to clients the nature of nontrading services being financed through commissions charged against a client's assets—half.

Over one-third of U.S. institutional brokers have illegal—that is, not research related, even by the SEC's generous definition—arrangements with investment advisers, none of which, zero, were revealed to clients. And almost two-thirds of soft-dollar arrangements are entirely undocumented.

Now, if you ask me to guess which of these statistics has changed since the SEC published this, the last one. Now the industry has learned not to publish anything with regard to soft dollars because it is just going to hurt you if the SEC does another sweep.

The second important point to make is that bad trading is very, very difficult to quantify and put in the expense ratio because it goes well beyond commission payments. So-called market impact costs of bad trading can often swamp the commissions. And in this case, it is exceptionally difficult to reveal the damage to fund performance to the fundholder. Therefore, what I would like to see us do over the long term is realign the interests of the fund manager with the investor by giving the fund manager the maximum incentive to get efficient trading. And we can do that by obliging the fund manager to cover the cost of commissions itself.

Now, of course, some are going to argue that is going to damage industry profitability, but I am not suggesting here that we should regulate management fees. What I am suggesting is that the problem would be very simple in a hard-dollar world. The investor would have two primary quantitative indicators that he or she would use in selecting a fund. One is that fund's record over time. Does that fund produce good performance? And, two, the management fee, which finally would be something meaningful. Right now it is not meaningful because the funds have a maximum incentive to shift costs out of the fund management fee and to hide them in soft dollars.

Mr. THOMAS. Senator, let me add one point. The gentleman just referred to the SEC 1997 sweep and alluded to "the inspection report," which I have a copy of here, and I referred to it in my verbal testimony. The SEC staff did not find one mutual fund that misused their client's commission dollars. In the executive summary of this report, the SEC says—and this is how they lead off this inspection report: "Research is the foundation of the money management industry. Providing research is one important, longstanding service of the brokerage business. Soft-dollar arrangements have developed as a link between the brokerage industry's supply of research and the money management industry's demand for research." This is quoted from the SEC.

Senator ALLARD. Mr. Chairman, my time has expired, but I would like to follow up just a little bit.

Chairman SHELBY. You go ahead. Take your time.

Senator ALLARD. If research is so valuable, Mr. Thomas, what difference does it make who pays for it? Will it survive? It is going to survive no matter who pays for it if it is so valuable, is it not?

Mr. THOMAS. Well, I think it will survive to a certain extent, Senator, but what will happen to the start-ups the people that we have seen over the 30 years that have, for the most part, come out of traditional brokerage firms? They have had better ideas, and a lot of times those ideas did not fly where they were. They started a service, and some needed help. We have loaned money through the years to help them get started, and they are extremely successful.

Now, what happens for the next wave? They may not have the opportunity to start up if you hamper just independent research. They will never have a chance to sell their product, because in a sense we are the sales organization of these products and services. They start up their firms, but they do not have marketing or sales staff. We use our sales people to help sell those products for them.

Senator ALLARD. So you end up subsidizing——

Mr. THOMAS. Subsidizing—no I said loan. My contention is that if the investment manager pays for the same independent research product with cash instead of commission dollars there will not be a savings. Without our support in the sales and marketing area, the independent research provider will incur more expense to provide the product. We are unbundled versus full serice brokerage firms. We show our clients the cost of the service. We provide an easier and less expensive way to obtain independent research.

Mr. BRADLEY. Senator, may I address that?

Senator ALLARD. Go ahead.

Mr. BRADLEY. I have a couple of concerns with the framing on some of these ideas. One is I have heard that we have an infinite amount of research available today that we did not formerly have and how valuable it is. But if soft dollars go away in any way, it will hurt the availability of research.

To your question, if it is really valuable, I do not know how we can assign that. Right now, we have fixed commissions. And so we have an infinite availability of "stuff" because the margins for everybody in this game are so high. In competition, the reason you want freedom of entry is so that it forces costs down and rationalizes the best players. And right now, in my opinion as a fund manager and one who purchases some of these services, the intellectual research, I do not know what the rationing mechanism is to make sure we have quality versus abundance. And I think that is a key question.

Senator ALLARD. I have had the opportunity to start my own business, and nobody subsidized me when I started out. The next question is: How do you decide who you are going to subsidize and who you are not? You know, I had to start small and struggled, but finally you break through. Go ahead.

Mr. EDELSTEIN. Speaking from the standpoint of one who started a firm, we started our firm about 12 years ago, and we had no assets under our management. So we had no commissions to use. We invested a substantial amount of our own money in this company, but over time we were able to build up clients and utilize the client brokerage to augment our internal research. We have also over the years added from our research staff of the original three professionals or four professionals to 13. We have continued to augment not only building up our usage of external research but also internal research. And I think it has been essential to our start-up.

I also want to correct one misnomer that commissions are fixed. In our company, at least, our experience is that commissions, since we started, have come down by over 50 percent, the commissions that we pay. And as we get larger, I think that will come down more. And I think also introducing the concept of scale into this, our firm at $2.8 billion, we are now being able to leverage our costs, both the internal fixed costs that we have invested in, as well as the external research. So, I applaud the large mutual fund firms who have, you know, $50 million——

Mr. BRADLEY. We were not large 15 years ago.

Mr. EDELSTEIN. You were large compared to other firms 15 years ago. The whole industry has grown terrifically. But they have been able to leverage these costs and now start to reduce the amount of services provided to them—or commissions that they have used to

buy services. I always think about these larger firms in terms of the aggregate amount of dollars that they use to spend on research. At some point when you are working with Merrill Lynch or Goldman Sachs, you have reached the highest level of commissions that they need to pay you the services—to provide you the services. Beyond that, it seems like it is excess. And as they get to that level, they should be able to reduce the commissions paid.

Mr. VELLI. Senator, if I could just emphasize one point, commission rates are clearly not fixed. As an agency broker, over 70 percent of our customers trade with us on an execution-only basis, not related to any soft dollars, and not related to any proprietary research. Also, we do not subsidize any of these independent research firms. They are viable businesses. They are growing. Some of them are very large. But they do rely on commissions as a fuel that generates their growth.

Mr. SCHILIT. Could I jump in?

Senator ALLARD. Yes.

Mr. SCHILIT. The question I think was most specifically directed to the independent research industry, and on this panel I am the only member of that, and the question was: What impact would it have on the viability of my company and my competitors if we went from a commission payment mechanism to a cash-only payment mechanism?

There is a very simple answer and with a very high degree of confidence: It would have a devastating impact, and more so on the smaller firms. My organization is one of the oldest and largest. It would affect me less than the newer players. But you do not want to create a system where only the big and the strong—for example, an American Century, which has an enormous wherewithal to put additional dollars in their budget, would be able to purchase research from a longstanding research firm, which they do, where a smaller firm, both a smaller and newer research provider and a smaller investment manager would not be able to participate at all. You do not want to have a system in place where only the big and the powerful can play.

I wrote down a few notes, and I want to just share the thoughts. One is research is research and commissions are commissions. Now, let me elaborate. If we agree that the appropriate currency to be used to pay for research is cash—and I have not heard any strong argument in that direction. But the only thing that should be used in the commission is the lowest execution price, a penny a share, 2 cents a share, and anything over that, whatever it is, for a big brokerage firm that is doing conferences or they are doing research, if the policy is that the only thing that can be used to pay for commission is the best execution on the trade. And everything over and above that must be paid for in cash. And Merrill Lynch put out a price sign for their research and said if you want to have our research, this is the cash price. I would in a moment sign off on that type of approach.

But that is not what we have. The proprietary brokerage firms today have over 90 percent of the business. One of my clients sent a year-end statement showing how much he pays in commissions and how much went to the soft dollar for independent research. Six percent—six percent—went to independent research, and he would

love to buy more and more independent research. And what is the right number? Should it be 99 percent that goes to the big brokerage firms? Should it be 100 percent?

The point is everybody should compete. So if a brokerage firm wants business, they have to be able to show they have the best price and the best execution. If a research provider wants to compete—and I want to compete—if you say you have—I have the cash price for my business. Fifty percent of my clients would write out a check. Fifty percent of them use the other currency. I do not really care. But I would care if you say the rules are different for my firm and for Merrill Lynch and for those firms. That, I think, is really the gut of where we need to focus. If we believe commissions are an appropriate currency to pay for research, then it is appropriate whether the research comes from a proprietary brokerage firm or an independent research boutique. I am not in the brokerage business at all. I put out a cash price for my business, and I sell it to investment firms.

Mr. BRADLEY. Including ours.

Mr. SCHILIT. Such as American Century, and I sell it to other people. But if you are going to ban the use of soft dollars, there are smaller firms. So American Century has the ability to put X millions of dollars in their budget as a line item for research. Smaller firms who do not have that type of ability will not be able to have access to our research. That is not good for the investor. We do not want to protect the big, longstanding firms at the expense of the newer ones.

Mr. BRADLEY. May I respond?

Chairman SHELBY. Go ahead.

Mr. BRADLEY. My company was started in the late 1950's as a small company. We didn't manage more than $1 billion until the 1980's. We were little. We have never done the third-party structure, always adhering to what we call the pre-1985 standard.

But as you walk down this path of decisionmaking, at many firms, , it becomes apparent that portfolio managers have a veracious appetite for "free" services. We recruit from other investment management firms. If a portfolio manager says, "I have to have this to do my job," many advisers tell the trading desk, okay, we need this service.

At our shop we annually have a big fight over what we really need in terms of services, because there are 50 guys pounding on our door every week wanting us to give them commissions. And when we pay cash for these services that are not part of our execution function, it is a fight because it is coming out of real cash that you have got in your investment company profits. It comes out of the profits.

The rationalization function is really important to having quality and investor benefit. Right now, I do not know how to attribute any value to what we purchase. And I think that would really be helped if this was more explicit.

Chairman SHELBY. Mr. Steil.

Mr. STEIL. Two very, very brief points.

First, research is just another form of consulting. An industrial firm that wants advice on how to service its clients better could do that internally, or it could go to a McKinsey.

I, for example, in addition to my work at the Council on Foreign Relations, do my own consulting. I consult for securities exchanges, securities firms, mutual funds, and SRO's, both in the United States and in Europe. Recently, for example, I consulted for a mutual fund that wanted advice on soft commission regulation in the United Kingdom. All of those firms have chosen to come to me and pay me with their own assets for my advice because they found it worthwhile in servicing their clients. They could have, for example, just gone to my website and downloaded every piece of research that I have ever published for free, but they chose often to contract me to do proprietary research for them because they found it of value to them in their business. I do not understand why the mutual fund business should be any different.

Second, the reason that this problem is getting worse and worse year after year is that the implicit cost of research is rising very rapidly. What do I mean by that? Mutual funds now can trade directly on electronic trading systems. They are proliferating, like Archipelago and Instinet. Many European exchanges allow mutual funds to be members. The only reason the brokers are there, still there in the first place, despite this proliferation of direct electronic trading, is because they facilitate this soft-dollar business.

So as Harold mentioned at the outset, the cost of full-service brokerage has hardly gone down at all over the past decade, from about 6 cents a share now down to—what?—about 4½ cents a share. Meanwhile, we have got direct access execution costs down to as low as half a cent a share. That gap is growing year after year, the gap between full-service commissions and direct access electronic commissions. That is the implicit cost that the investor is paying for these consulting services.

Senator ALLARD. Thank you, Mr. Chairman. I did not realize that last question was going to stimulate that amount of discussion.

[Laughter.]

But I do think that it has been helpful for us to hear that.

Chairman SHELBY. As an alternative to repealing Section 28(e), some have suggested that the SEC should require broker-dealers and mutual funds to unbundle the cost of research and execution and assign values to each service. Some claim that this unbundling would create more transparency and eventually lead to lower commission costs for investors.

Would you comment on the impact of unbundling on soft-dollar practices? Also, if commissions are unbundled, should the soft-dollar costs of research be included in the expense ratio?

We will start with you, Mr. Bradley.

Mr. BRADLEY. Thank you, Chairman Shelby. I talked specifically about this within my written remarks to some extent.

The unbundling function is difficult because it has so many definitions. My recommendation would be for the SEC to gather and publish information similar to Rule 11Ac1–5 that the Commission established for exchanges. Exchanges are required to report certain metrics every quarter or every month on their quality of execution and trade. In the commission field, it might be done in a similar fashion. I would like to see the SEC require broker-dealers to report quarterly their execution-only rate as negotiated with all their

clients, and then see the SEC aggregate that number into an industry-wide, execution-only average commission rate.

The reason I would want the SEC to do that is to provide an opportunity for those who are negotiating to do so in a way that they can get lower cost or pay for higher value and justify that to preserve the possibility of competitive rate-making.

Chairman SHELBY. Would that be added cost to the industry, though?

Mr. BRADLEY. I assume what you are going to have to do is get the brokers to disclose what they identify as an execution-only rate, and I am not sure most of the major firms have identified that yet.

However, firms like Archipelago, Bloomberg, and other execution-only broker-dealers, will easily be able to report the cost of doing the trade, usually 1 cent a share or less. It would require some definition, I am sure, and interpretation.

Chairman SHELBY. Mr. Edelstein.

Mr. EDELSTEIN. First of all, I would like to just comment that there is no one execution-only rate because trades require varying degrees of attention by brokers. We have a lot of smaller trades in companies that are smaller-cap that require a lot more attention. And in order to have the broker work this trade over several days, they want to be paid for it. So there is no minimum commission out there that I think is definable.

In terms of the unbundling proposal, I think that that would create more transparency, and I think that would be very interesting. However, I think that should be the burden of the broker, not the adviser, to break out that cost.

The concern I would have with it, though, is that it could end up reducing the overall coverage level of stocks in the universe because the brokers may find that it is not profitable to cover a lot of smaller companies. This could result in less liquidity in the markets and less information.

Chairman SHELBY. Mr. Schilit.

Mr. SCHILIT. Yes, I think your question really gets at the heart of what the solution is. By requiring the brokerage firms to present an à la carte menu—it has always been bundled together with the execution and conferences and institutional sales. It is all bundled into that one number. By requiring all brokerage firms to unbundle and disclose what the à la carte cost is for every one of them, then an American Century and a Westcap can have the flexibility to pick and choose. Do they want to get research from Morgan Stanley? Well, if it is not part of the package price, they may decide that they want to get research from other sources. So, I think the cost of the trades will invariably go down, which is good for the consumer.

Chairman SHELBY. The shareholder.

Mr. SCHILIT. The shareholders. The access to the best research and only the research you want to buy, and if you want to pay cash, you could pay cash. If you want to, you know, bundle it through some third party—but everybody knows what they are buying.

So once we do the unbundling, then the second part of your question with the expense ratio, that is the easy part, because once we know what is included, then if the regulators say research from

whatever source should be included in the expense ratio, that is what I would propose. Again, whether it is an expense ratio or management fee, but, you know, it cannot be hidden.

So as the gentleman next to me was saying, he does consulting, he gets paid cash for it. I do seminars and consulting; I have a cash price for it. So the expense ratio I would like to see including research from any source.

Chairman SHELBY. Mr. Steil.

Mr. STEIL. There are two basic types of unbundling. One is the unbundling that takes place before the trade when the fund manager has the right incentives. In other words, the only reason that the fund manager bundles now is because he can use his client's assets to fund his operating costs.

Chairman SHELBY. The client doesn't really know, does he?

Mr. STEIL. The client doesn't really know that, and it is not well disclosed at all, and that was well documented by the SEC back in 1998. The unbundling that you are describing is an ex-post unbundling. It is an accounting unbundling after the fact. That will naturally lead to a huge debate in the industry as to what an execution actually costs. The full-service brokers are going to have maximum incentive to say that the execution component is as expensive as possible, probably in the range of 3 cents a share. Personally I think that would be untenable to maintain when you have already got direct access electronic brokerage fees down to around half a cent a share.

But if it is just going to be an accounting exercise, Senator, I see a problem there because the basic conflict of interest in the industry is going to remain. In other words, the fund managers and the brokers together will have maximum incentive to disguise what fund managers are really paying for services above and beyond what they actually need to execute a trade efficiently.

Chairman SHELBY. Mr. Thomas.

Mr. THOMAS. Senator, the expense ratio is not my expertise, but let me touch on the bundling. At present, the investor can select a manager that pays cash for all the research—that is independent research. The manager cannot pay cash for research from full-service brokerage firms.

As far as an execution-only rate, there are many different rates. There are ECN rates that were referred to in Mr. Bradley's chart of Archipelago. There are rates that full-service firms might charge for execution-only. There are direct access rates where you call directly to, say, the floor of the New York Stock Exchange. The rates all vary, and they could be anywhere from a penny to 3 pennies. Then there is expertise. You really cannot give an ECN—such as Archipelago so that we were referring to earlier—an order to sell 5 million shares of Coca-Cola, market not held, use your discretion. It does not really work that way.

I want a trader that can take the order, walk away from it, and when the stock gets out of the range, come back to it, trade when they want to trade and execute the order by using their expertise.

So, I think we have the ability now for many types of execution rates if you want to go that way you can, except for the full-service firms. Their rate is usually combined with brokerage, their research.

Chairman SHELBY. Mr. Velli.

Mr. VELLI. I think we are overcomplicating this. I look at it in a very simple way. As an agency broker, we fully disclose how much a trade costs from an execution standpoint and how much of the commission is going——

Chairman SHELBY. Who do you disclose that to?

Mr. VELLI. We disclose it to the asset manager.

Chairman SHELBY. Okay, but not to the fundholder.

Mr. VELLI. No. And as I said before, we do advocate that the asset manager disclose how they are using their commissions. But as an agency broker, as I was saying, we do fully disclose how much of the commission we are receiving is going to purchase independent research and how much is going to execute the trade. And the portion that is going toward executing the trade is fully negotiable.

I am not in the business of defending the full-service firms. I compete with them. But I think that you would find it very difficult—or they would claim that it is very difficult—to unbundle their commissions from the other services contained in their rate. But I would also advocate that an asset manager has a choice. He does not have to deal with a particular broker if he does not want to on a bundled basis. He could go to an agency firm, he could go to many other full-service firms and negotiate an execution-only price. The only reason why he wants to trade with that full-service firm who may be unwilling to unbundle is because he highly values the research being supplied. And so that is the cost of purchasing that research.

Chairman SHELBY. Senator Sarbanes.

Mr. BRADLEY. Mr. Chairman, may I just add one additional point that I neglected to include?

Chairman SHELBY. Proceed.

Mr. BRADLEY. One of the biggest problems we have here is the United States, just as we were the last market in the world to go to decimals, is that we are the last market in the world—except for Canada—to charge cents per share on trades, which makes no sense to me at all. If a stock is trading at $100 a share today and splits 3 for 1, I pay 3 times the commissions tomorrow for the same dollar value of the company. Across the world, all of us who trade globally have systems set up to do that as a percent of principal.

Chairman SHELBY. What does that do for you?

Mr. BRADLEY. Let me explain the positive impact for investors. In 2000, if I was paying a nickel on a $25 stock and it dropped during the bear market to $10, I am now paying a much higher value for the same percent of that company than I was at a higher stock price. And so there is a negative incentive in that the percent of commissions paid to trade a stock by investors goes up as stock prices come down. I think that is not aligned very well with investors' interests. And I would argue we should begin to require reporting in percent of principal terms, both trading costs and commissions.

Chairman SHELBY. Senator Sarbanes.

STATEMENT OF SENATOR PAUL S. SARBANES

Senator SARBANES. Thank you, Mr. Chairman.

I apologize to the panel I was not able to be here at the outset, and so if the question I asked has been put before and you have responded, maybe you could summarize your answers. I just have a very basic question. What do you see as the consequences of just repealing 28(e), just not having that safe harbor at all available? This, I take it, would put people back to having to judge what their fiduciary duty was as they proceeded.

Mr. BRADLEY. Senator, I would like to try and address the idea of repealing 28(e). It may surprise some that we would not support repeal. We have been a very vocal critic of many of the uses and safe harbors created by interpretation within 28(e). I am concerned about the use of research in one specific application. Most of what we are talking about is focused on the investor and returns used to fund his retirement and his children's education, really important topics to be sure. But the capital markets were created as a place where people can go with ideas to start a business and build jobs because they cannot borrow money on favorable terms at the bank for the risk the bank would have to take.

Now, I believe that research does provide a valuable service for those new companies that come public that is really, really important. So while I think that repealing 28(e) could have some very positive impacts, I do think there could be some unintended consequences on the capital formation part of the market. I am a small company investor, and I may be overstating that because obviously things fill the void, and if you pay cash you are going to maybe get better research. But it will not help those small companies get advertised as fast when they have a good business and they might have to build those businesses more slowly.

Mr. EDELSTEIN. I think repealing 28(e) would have a disproportionate impact on smaller advisers and give a significant advantage to larger advisers. Smaller advisers do not have the large in-house research staffs, and we tend to rely somewhat more on external research from both proprietary sources and third parties. And as such, you know, if we did not have the ability to pay for these services in soft dollars or with commissions, we would have to make some decisions about which services we did pay in hard dollars because we probably could not afford all of it. Ultimately, that could hurt investors.

The other choice, I guess, would be to raise fees, but I think in this environment that would be very difficult to see how that would happen.

Mr. SCHILIT. Senator, when I gave my introduction, I described that I run an independent research firm, and so I talked specifically how it might affect my organization and some of the small competitors. Ten years ago when I began our research center—an integral introducer of clients—a marketer for a firm were the agency brokerage firms, and that certainly saved a lot of cost in terms of not having to hire a marketing staff. I think the repeal of 28(e) would have a very adverse impact on the viability of many independent research firms, particularly the smaller new ones, so the firms are emerging.

I spoke at the first Independent Research Conference in New York about 2 weeks ago, with about 300 fledgling organizations, more than half of them did not exist a year ago. And many of those

organizations will not have a chance to blossom and to be able to show their services to investment managers if 28(e) is repealed, and smaller investment management firms will also suffer because they will not have the opportunity of benefiting from that research.

Mr. STEIL. Repealing 28(e), Senator, in my view, would be a significant step forward because it would establish the principle that trading commissions are to be used specifically for trading. In Figure 1 of my testimony, I document services that fund managers are currently legally paying for with trading commissions, and many of these services, Senator, have absolutely nothing to do with trading whatsoever. My fear is that even with repeal of 28(e) fund managers and brokers will still have an incentive to push the invisible services that brokers are kicking back to the fund managers, underground, push them underground, make them invisible to regulators entirely.

The point has been made on this panel before that the fund manager currently has free choice whether to bundle trading commissions or whether to unbundle them. The problem with this choice is that we know that they prefer to bundle because every time they bundle they outsource using the clients' assets. When they unbundle they are funding things like computers and conference registrations and research—they fund that with their own assets. That is why they do not want to do it. You have much too much of these services being outsourced right now, specifically so that the fund manager can use the clients' assets. A more radical solution to this problem that I support was outlined in the 2001 Myners Report to the Treasury of the United Kingdom, which recommended that fund managers bear the cost of their own trading commissions.

In my testimony, I explain that an average fund manager could recoup the cost of bearing those trading commissions by raising its management fee about 18 basis points, but this would still leave the fund holder better off by about 50 basis points because the trading would be so much better and so much more efficient. So, I think the best way to unbundle is to give the fund manager the incentive to bargain the cost of all the services he is using, whether they be trading, research, or otherwise.

Mr. THOMAS. Senator, this is probably the first time I have been in agreement with Mr. Bradley, but I am, with these comments. I think it would have a real disadvantage to start-up money managers and also the new research providers. Then if you look at the goal of Mr. Spitzer's global research settlement, which was to have more research, that is, more independent research, I think we definitely need to go along those lines.

Mr. VELLI. Again, I have a habit of simplifying things, but when I look at this, research drives the investment process without the idea generated from research whether I am an individual buying a single stock or if I am investing in a mutual fund, I am appointing that mutual fund to act as my agent, and research drives the process. By eliminating 28(e), there is no question in my mind it would have a devastating effect on the independent research community as well as the full service firms, cutting down on the amount of research available in the marketplace.

Senator SARBANES. In a 1998 SEC staff study of soft dollars, 35 percent of investment managers examined had used soft dollars to pay for nonresearch items, including employee salaries, rent, association fees, travel expenses and dinner, parking fees, limousine service, and concert tickets. Is there anyone at the table who contends these practices or feels that these are legitimate purchases for soft dollars?

Mr. VELLI. Not at all.

Mr. THOMAS. No.

Mr. BRADLEY. Senator Sarbanes, I do not think they are defensible but if you look at the language——

Senator SARBANES. How would you eliminate the practices? Very quickly, because I am running over my time.

Mr. BRADLEY. If you look at the language in 28(e), it would suggest that this should not even be allowable. It was the interpretive release by the SEC in 1985 that opened the door to all these other things, and in my testimony and some of the questions I have already responded to, what we would do is preclude many of those things by amending 28(e).

Senator SARBANES. By statute.

Mr. BRADLEY. By statute.

Mr. EDELSTEIN. I think that all of those, to me, are currently outside of the safe harbor, and I believe that the approaches I would take to encourage more conservative practices by managers, and adherence to the safe harbor would be better disclosure, enhanced disclosure, better recordkeeping required of the managers and a narrowing of the definition of research, particularly to exclude, clearly exclude things that are available on the street corner like *The Wall Street Journal, Business Week,* or perhaps computers, things that you can buy at the store.

Senator SARBANES. Who should know the definition?

Mr. BRADLEY. I think the SEC should know the definition.

Senator SARBANES. Who expanded the definition?

Mr. THOMAS. It was reinterpreted in 1986. And, Senator, those items are not allowable.

Senator SARBANES. By whom?

Mr. THOMAS. By the SEC.

Senator SARBANES. And, Mr. Edelstein, you think that the SEC should——

Mr. EDELSTEIN. I think the practices that you spoke of that they discussed in their report were outside of the safe harbor.

Mr. VELLI. We do not believe they are currently allowable.

Mr. THOMAS. They are not allowable under 28(e).

Senator SARBANES. A lot of people are doing it apparently.

Mr. VELLI. And that should be stopped.

Senator SARBANES. Mr. Steil.

Mr. STEIL. You pointed out services that are outside the safe harbor, but I think the more important point is services that are within the safe harbor that are perfectly legal. Just to give you a few of them: Newspapers, magazines, online services, conference registrations, accounting services, proxy services, computers, monitors, printers, modems, cables, software, network support, and maintenance agreements. All those things are 100 percent legal according

to our Securities and Exchange Commission. Those abuses, in my view, should be eliminated.

Senator SARBANES. Thank you, Mr. Chairman.

Chairman SHELBY. Senator Schumer.

STATEMENT OF SENATOR CHARLES E. SCHUMER

Senator SCHUMER. I am getting a little perturbed here. You mean if you have to buy a newspaper in a small town to learn about a business, that is an abuse? A newspaper, *per se,* is not an abuse. That is what research is all about. So are certain online services what research is all about. I mean going to a concert is a lot further away than online services, is a lot further away than buying a newspaper. Now, it is *The New York Times* and you are getting it anyway, and it is your subscription, that is one thing. Buying some—you know, the *Journal of Commerce,* which you might only read to do research, you are not reading it to become a better informed citizen, that seems to me to be perfectly legitimate. Do you disagree, Mr. Steil?

Mr. STEIL. I strongly disagree with that, Senator.

Senator SCHUMER. Why is it illegitimate to buy a newspaper to do research?

Mr. STEIL. As I said earlier, in addition to my work at the Council on Foreign Relations, I also do consulting. I do consulting for securities firms, securities exchanges, mutual funds, and SRO's. In order to do that consulting, I read *The New York Times*, *The Wall Street Journal*, and the *Financial Times* every day. I use specialist journals. I use all types of research tools. I do not pass on the cost of my educating myself to my client. That is part of the service I am offering my client, being an educated adviser.

Mr. BRADLEY. Senator Schumer, may I respond as a large money manager? I have almost all of my money in our funds, and as an investor in those funds I pay a management fee of 1 percent, and I expect that my manager can turn on his lights, can turn on the computer, can use whatever systems he can to deliver results, and that is why I pay a management fee. My concern about this is that it is not part of the management fee, it is not disclosed, it is hidden and it is a subsidy, and that we should eliminate that. If it is legitimate, I agree, we need those things, but what are people paying the fund management fee for?

Senator SCHUMER. Right, Okay. I am not sure I agree with you, Mr. Bradley, but that is a different point than saying any newspaper, any online service is not part of research. You can decide how to disclose it and who should pay for it, et cetera, but it is research, and the idea of making yourself a well-informed person should all not be part of research, well, making yourself a well-informed person one way or the other.

Let me tell you, I think this hearing is very important, but I think we really, again, run the risk of throwing out the baby with the bath water. As many of you have underscored, research is key to our capital markets and it is key for the small investor in particular, because if you are a big investor you can do your own research any way you want, and a small investor cannot. The idea, especially after Eliot Spitzer's settlement which said we need inde-

pendent research, to now go ahead and say, well, let us be so counting angels on the head of a pin.

Well, my father, a small stock investor, cares more about getting good research as a package then going out and finding his own research firm before he buys 50 shares of AT&T or whatever he is buying. And the logical free market response here is disclosure, and if people want it, fine, and if they do not want it, fine. Mr. Steil, you are imposing your own views on every investor and saying they should do it your way, and that is not right, and that is not fair. I have to tell you something else, it will, academic theories notwithstanding, lead to a great decline in research and particularly a decline in research for the little guy. One of the things I am terribly worried out, there are all these rules.

There is a book called, *The Logic of Collective Action* by Mancur Olson, . It is a brilliant theory, where he said, there are certain things that are societal goods that require a thousand or a million of us each saying we will be part of a little bit, but if each individual were making a totally rational decision for himself or herself, they would say, I do not want to pay for it. So you add up those one thousand each rational decisions, and society declines because you do not get the overall good. That is a book which I would commend to you, *The Logic of Collective Action.* I have to tell you, I think your views are rarified, are very academic, and do not make any sense in the real world, in all due respect.

To say that we have to go beyond disclosure, which is a fundamental free market tenet, and we should always make disclosure better and better and clearer and clearer, and you want to break it down so people know exactly what each thing is. I mean you get to a point where people cannot understand it too, so there is balance there. But let us be practical here. The real worry we have is not that people might be paying one-tenth of a cent more. I mean I understand free market theory would say that is the goal, but there are certain externalities that are good for the market and have proven to be good for the market and research is one of those. Your view, if somebody wants to pay for research, let them, and do not even allow it, once fully disclosed, I believe will lead again to a dramatic decline in research and particularly a decline in research for the small guy.

To tell that person he cannot have the research once it is disclosed, and he has to go out and buy all these services separately, is like saying, if you buy a General Motors car, you cannot have General Motors put its engine in there, but you have to have General Motors provide a brochure and you can decide a Ford engine, a Chrysler engine, whatever.

I mean we are getting to the point of absurdity here, Mr. Chairman. Anyway, since I was my usual mild-mannered self.

[Laughter.]

Please, Mr. Steil, respond.

Mr. STEIL. Senator, my father is one of those small investors you are talking about. My father had a very modest upbringing. My father has never had a defined benefit company pension in his lifetime. So the way his fund managers, like Harold Bradley, spend his money is very important to him. He asked me why I was coming before this Committee to testify, and I explained to him what

soft dollars were about. He was very surprised. He thought that when he paid a management fee to an investment management company, about 1 percent of his assets, that the rest of his assets were being invested and that the fund manager knew how to pick stock, did not have to use the rest of his assets to pay somebody else behind his back to decide what stocks to pick. He thought he was buying——

Senator SCHUMER. Disclosure will deal with the "behind his back" aspect of this, and then your father will know and make the choice. Why are you saying the way your father wants to do it should be the way my father has to do it?

Mr. STEIL. Disclosure will not work because of the fact that the commissions are bundled today. They are all bundled together in one package which gives the fund manager a massive incentive to fund as much of his operating cost as possible through trading commissions——

Senator SCHUMER. Does everyone agree with that?

Mr. BRADLEY. Senator Schumer, I will tell you that what has not been said today, one of the reasons at American Century we have been so—and I tried to avoid it, but I am not going to now. We have tried for years to get Wall Street to go lower on bundled rates with us because we do not value their services to us as high as they do, and they will not break certain levels. They go to a certain set level, they will not break it. If they do for one, they do for all.

The way we have put pressure on and gotten some is by moving more and more of our business to electronic trading venues, which is an execution-only function.

Senator SCHUMER. There you go.

Mr. BRADLEY. But that again, most people——

Senator SCHUMER. You have made my point.

Mr. BRADLEY. No. We choose not to do this and we forego tens of millions of dollars of profit every year by trying to do what is right. We think it is wrong for investors to be paying fees that are not disclosed.

Mr. STEIL. Senator.

Senator SCHUMER. Can I just have Mr. Thomas and Mr. Velli respond.

Mr. VELLI. First, I would like to say, Mr. Bradley, I will be happy to talk to you after this meeting because we will negotiate our execution rates. You know, there is a choice that an asset manager has as to how they deal.

Senator SCHUMER. Maybe the big boys will not, but there are a lot of people in the market who will negotiate as I understand it.

Mr. BRADLEY. The big boys are the guys with the investment banking books, and if we do not deal with them, we cannot buy the new companies.

Senator SCHUMER. That is a different issue. That is a totally different issue.

Mr. BRADLEY. That is a completely related issue.

Senator SCHUMER. Then you do not want to have any—you want to break every——

Mr. BRADLEY. I want competition. I want competition.

Senator SCHUMER. —in the Financial Services Act, which we just passed——

Mr. THOMAS. I think we have plenty of competition today. I know just in the area that Mr. Velli and I are in, we probably compete with 250 firms every day. There is plenty of competition. And our clients can pick up and leave us any day if we do not inform them properly.

Senator SCHUMER. Could Mr. Bradley call you up and negotiate a lower rate?

Mr. THOMAS. He absolutely can.

Senator SCHUMER. Do other of your clients do that?

Mr. THOMAS. Absolutely they do, Senator.

And I would add I think our execution is as good as any full-service firm. In fact, in many cases we have a larger amount of volume going through an agency desk than a full-service firm. So there is plenty of choice out in the marketplace.

Chairman SHELBY. Let me ask a question briefly. Disclosure is important, I agree with Senator Schumer on that. Then the question is, should we statutorily repeal 28(e) or should we push the SEC for more disclosure?

Senator SCHUMER. Exactly that is the question.

Mr. THOMAS. SEC, more disclosure. I think it is in their study they did in 1997 and their 1998 recommendations. As I said in my verbal statement, we totally endorse those recommendations.

Chairman SHELBY. Go ahead, Mr. Steil.

Mr. STEIL. My solution, Senator, goes beyond repeal of 28(e). I would like to challenge your assertion that it is academic. You can find everything that I am advocating online in the Myners Report prepared for the Treasury of the United Kingdom by Paul Myners, who was the Chairman of Gartmore Asset Management, one of the largest asset management firms in all of Europe. This is not academic, Senator.

I should also point out that my solution that I am advocating, if you look at the appendix to my testimony, you will see that it will help fund holders because even if fund management companies raise their fees by 18 basis points to cover the cost of all the hard dollars they are going to have to lay out for research, fund holders will still be better off by about 50 basis points because their money is going to be used——

Senator SCHUMER. But, Mr. Steil, the externality of lower research, less research, might be worth a heck of a lot more than 50 basis points. That is the forest and you are talking about trees.

Mr. VELLI. Senator, can I just make one comment, please? I have been hearing a lot about Paul Myners. Paul Myners is on our board of directors, and I think it is important that you read some of his editorials that have come out on this subject since his original statement. And he is a supporter, in a lot of ways, of research, and especially independent research.

Senator SCHUMER. What does he say? Where does that lead him, given his report?

Mr. BRADLEY. The FSA just yesterday came out with recommendations they are going to release. We have put it into the record today, that is heading toward unbundling in the United Kingdom.

Mr. SCHILIT. Senator, I just wanted to underscore, when you used the expression, throwing out the baby with the bath water,

you could not be more on target. If there is one resounding message, the investor will be heard more not because the commission goes up 20 basis points or 11 basis points or 50 basis points. The title of my presentation is "Unintended and Undesirable Consequences of Banning Soft Dollars." And I know, because I sell independent research, I know for a fact what has happened in the United Kingdom with the Myners Report. Fund managers are no longer buying independent research. I know what is happening in the United States, as fund managers are moving from soft-dollar arrangements to hard dollars. They are not buying independent research or they are buying from fewer sources, and they are buying perhaps only from the well-established ones. Again, the big boys, the big investment management firms like MFS and like American Century have the wherewithal to buy it. Those firms can put an additional $15 million in their budget. A small firm like Westcap does not have that kind of flexibility.

So before we repeal 28(e) we should look so carefully at what are the alternatives short of that that if there are abuses and people are buying things that are inappropriate, you and Mr. Steil can argue all day long in terms of what should be included and what should not—and that is appropriate to argue about that. But if we have the unintended consequence of eliminating independent research——

Two years ago, as I mentioned early in my testimony, I was sitting on another Congressional panel on the Enron hearings, and sitting side-by-side with me were four proprietary research analysts who all had strong buy recommendations. None of them had the ability or the gumption of the backing of the firm to come out and say, there is something very wrong here. All of the warnings that the investors received during the horrible accounting frauds, came from independent research firms. So if you think what happened a few years ago—Senator Sarbanes walked out—but if you think what happened a few years ago was bad for the investors, stay tuned how bad it is going to be the next round.

Senator SCHUMER. These are the external benefits of independent research that far exceed a 25 or 37 basis point to the small investor and to the markets, and we are getting to again here—that is why I think this is truly academic, as opposed to practical and real.

I worry about, as capitalism becomes more pure and everybody pays for each little thing, another argument in economic theory, which is externalities, get lost. And a lot of externalities have helped this country, Adam Smith economics work, and the markets, and we are getting away from that and I worry about it. So, I will be—I have to leave—I agree with you, Mr. Schilit.

Chairman SHELBY. Senator Schumer before you leave, I have a couple comments, and then we will let the panel continue. I have a couple comments.

I agree with Senator Schumer in that central to all investing is research. It is central. The question is how do we deal with it? I believe research should be research. You know, apples should be apples, they should not be oranges or grapefruit or broccoli or anything else. So how do we deal with this?

Could not the SEC, if they wanted to, if they had the will, deal with this under their authority short of us getting into this statutory area? This is why we hold these hearings.

Senator SCHUMER. Right. It is my belief they could not, Mr. Chairman.

Mr. BRADLEY. Senator Shelby, in 1993 and 1994 Congress held hearings on this. There were meetings and regulatory roundtables in 1987 and 1988. This has come around every 3 or 4 years depending on the tone and tenor of the market, and there has been no further resolution of this problem.

Chairman SHELBY. Mr. Edelstein.

Mr. EDELSTEIN. I just wanted to make one other point about the United Kingdom. Their structure, their market is much different. They are dominated by large institutions. In the United States, we have over 8,000 SEC registered investment advisers.

Chairman SHELBY. And we benefit from small, emerging firms.

Mr. EDELSTEIN. And 70 percent of them are less than 10 employees, so it is much different.

Chairman SHELBY. Mr. Steil.

Mr. STEIL. Two very brief comments, one as a starry-eyed academic. I happen to be a Ph.D. economist, and one thing that annoys Ph.D. economists is abuse of the term "externalities."

Chairman SHELBY. I do not think this is an academic question. I think this is an argument.

Mr. STEIL. I could not agree with you more, sir. I want to refer to the economics term that Senator Schumer used which is "externalities." There are two types of externalities in economics. One is technological, one is pecuniary. A technological externality is one for which there is not a market solution. That is, for example, I produce pollution which affects your backyard and I am not absorbing the cost. Those are the types of externalities that economists say regulation is necessary for.

The other type is a pecuniary externality, which is entirely intermediated by the price system. In other words, we can pay for research. It is available out there at a market price. I do it, Mr. Chairman. I provide clients with research at a market price. It is not unavailable.

Also, with regard to the nonstarry-eyed academic, Paul Myners, former Chairman of Gartmore, I will just read you very briefly what he said in his report to the United Kingdom Chancellor of the Exchequer. "Clients' interests would be better-served if they required fund managers to absorb the cost of any commissions paid, treating these commissions as a cost of the business of fund management, as they surely are. Fund managers would of course seek to offset this additional cost through higher fees. This would be a matter for them to agree with their clients. Under this system the incentives would be different. Institutional clients would see more clearly what they were actually paying to have their funds invested."

That is all I want, Mr. Chairman. This is not starry-eyed academics.

Chairman SHELBY. Mr. Thomas.

Mr. THOMAS. Mr. Chairman, we would welcome some direction from the SEC, more clarification.

Chairman SHELBY. Mr. Velli.

Mr. VELLI. We agree. My biggest concern right now is that many asset managers have stopped using independent research and I think some action has to take place sooner rather than later to encourage them, once again, to start to use independent research for the benefit of investors.

Chairman SHELBY. Will the market not really work sooner or later? If they do not have the proper research, the fund is generally not going to do as well. People work for their fee, do they not? If I were investing in any of your funds and I got burned, I am probably not going to stay there. I would say, what is going on? As opposed to somebody who invested in research. You have to invest in research. It is a question of what do you call it and what constitutes research? I do not think opera tickets constitute research, although that would be nice. I do not think football tickets constitute research. But what are the parameters? Is that not what we are getting at?

Mr. BRADLEY. Exactly right, sir.

Chairman SHELBY. And could not the SEC deal with this?

Mr. BRADLEY. Yes, with a little nudge.

Chairman SHELBY. They will get more than a nudge.

[Laughter.]

Gentlemen, we have had a full and frank exchange and that is what hearings are about. Thank you very much.

The hearing is adjourned.

[Whereupon, at 11:58 a.m., the hearing was adjourned.]

[Prepared statements and response to written questions supplied for the record follow:]

Written Statement

of

Harold Bradley

Chief Investment Officer, Growth Equities
American Century Investments

Before the United States Senate Committee on
Banking, Housing and Urban Affairs

Hearing to Review

Current Investigations and Regulatory Actions
Regarding the Mutual Fund Industry:
Examining Soft Dollar Practices

March 31, 2004

American Century
Investments

Introduction

Thank you Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee, for inviting me to offer the perspectives of American Century Investments on the need to fix our industry's "soft dollar" problem. American Century has always taken the position that commissions are investor assets and, as such, should be transparent and used only to directly benefit the investor - not the investment adviser. Our business practice and public advocacy for more than a decade have reflected this point of view.

American Century Investments is an investment manager for institutional accounts and more than 60 retail mutual funds. We manage about $90 billion for 1.5 million investors. Today, I oversee twenty investment professionals, including ten stock analysts, who manage six investment portfolios. I am also the portfolio manager for two funds and serve on our firm's Investment Oversight Committee - I understand the role Wall Street research plays in the effective management of mutual fund portfolios.

Earlier in my career at American Century, I established and managed our global trading operation with day-to-day responsibility for trading equity securities. Thus, my views reflect a career spent both <u>managing</u> AND <u>trading</u> equities for mutual fund portfolios.

It is clear to me that the present law governing brokerage transactions needs to be changed. Previously, I offered testimony before Congress to support pro-investor reforms in the areas of decimal trading and stock exchange structure improvements. Today, I ask you to consider significant action to address complex and arcane soft dollar practices.

What Should Congress Do?

Section 28(e) of the Securities Exchange Act provides a "safe harbor" for investment advisers to use their discretion in paying brokerage commissions that exceed the execution-only rate without violating their fiduciary duty to achieve "best execution". Excess commissions are called "soft dollars". While Section 28(e) implies the investment adviser's discretion is to be exercised for the investor's benefit, SEC interpretations of the provision allow advisers to "pay up" for almost anything that assists their investment decisions. In practice, soft dollars often find their way back to the adviser directly or in the form of research or other ancillary services. This activity transfers billions of dollars from investors to market intermediaries. To ensure that investors' commissions truly benefit only the investors who pay them, to cure conflicts of interest confronting money managers and traders and to address real and perceived soft dollar abuses, we recommend Congress:

1. **Amend section 28(e) or direct the SEC to define "research" in a way that precludes soft dollars being used for:**
    - **Computer hardware and software;**
    - **Publications, including books, periodicals, newspapers and electronic publications;**
    - **The costs and fees associated with professional development seminars;**

- Exchange data fees for quotes and services; or
- Any service from third party providers otherwise available for cash to the general public, such as compensation consulting, printing, phone bills, etc.;

2. Prohibit fund advisers from taking into account sales of fund shares in allocating fund brokerage;
3. Require the SEC to gather and publish an industry average execution-only rate from all registered broker dealers. The SEC should do this to preserve and encourage competitive rate-making that does not currently exist in what appears to be a "fixed" commission rate environment.[1]
    - Require that this execution-only rate be reported as a percent of principal traded, as is the custom in most markets outside the U.S.[2]
    - Direct the SEC to define "best execution," consistent with guidelines put forth by the Association for Investment Management and Research.
4. Mandate soft dollar record-keeping.

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[1] This would be significantly analogous to the use of SEC rule 11Ac1-5 which compels periodic reporting by exchanges of uniform measures of execution quality. Instead, the SEC would gather and report a uniform measure of execution-only rates. Those firms paying more than the average rate, by definition, are acquiring additional research and services. Fund boards will then be able to explore and understand what additional costs are being borne by investors.

[2] A 5c per share charge on a 100,000 share trade of a $50 stock yields a $5,000 commission to a broker on a $500,000 investment in the publicly traded company; when that stock splits 2:1, a 5c per share charge on a 200,000 share trade of the now $25 stock yields a commission of $10,000 on the same $500,000 investment in the company. If the commission were charged as a percent of the "principal" amount traded, say .10%, the commission would remain $5,000 in either situation.

- Require investment advisers to maintain records of brokerage payments in excess of the average execution-only rate and to justify the services provided for the excess commission.
- Require brokers that pay soft dollars to third parties for services provided to investment advisers to provide a record to the investment adviser of all third party payments.
- Mandate annual or more frequent disclosure of soft dollar records to the mutual fund's Board of Directors and to the SEC during periodic audits.

5. Direct the SEC Division of Corporate Finance to adopt new regulations of investment bank activity where excess commissions paid by the industry's largest and most dominant players secure access to the "hottest" deals, to the exclusion of smaller fund companies and retail investors. Require underwriters to publish the size and identity of the 20 largest participants in new public offerings to make transparent any commission "pay to play" practices.

The following discussion supports these recommendations.

__The Time for Soft Dollar Reform Is Now__

American Century began aggressively seeking soft dollar fairness for investors in 1992 when we asked the SEC to look again at Section 28(e).[3] We warned of potential abuse, scandal and embarrassment and have since echoed our concerns repeatedly in publications and industry conferences.[4] Congressional hearings, regulatory sweeps, and intense lobbying by the beneficiaries of this investor largesse have delayed meaningful reform in the area of soft dollar practices. We do not believe further study is needed. Soft dollars are largely undisclosed.[5] They damage investor interests when used for things that don't directly benefit them. And they represent huge, hidden costs on savings and investment. The time to act is now. Prominent industry participants other than American Century realize this.

Recently Janus Capital Group, Bank of America and Morgan Stanley all publicly signaled their retreat from soft dollar usage. Fidelity Investments told the Securities and Exchange Commission (SEC) that "soft dollar research expenses are the least transparent of fund expenses, because they are "bundled" with payments for a distinctly separate service –

[3] "One might argue that allowing soft dollar trading to pay "research" bills under 28(e) constitutes a fleecing of investors who are billed twice--implicitly and explicitly--for the same service. Investors pay a fee for a professionally managed investment. IRC believes this fee should pay for **all** necessary information to make intelligent investment decisions. However, soft dollar trades imply that a cost above the management fee is required to purchase appropriate investment research. Soft dollars in many respects serve only to pad the margins of money managers." Nov. 18, 1992 letter to Jonathan Katz, SEC, from Investors Research Corp. (predecessor of American Century Investment Management).

[4] See Appendix A, "Views of an Informed Trader," Harold S. Bradley, May, 2002, AIMR Conference

[5] Soft dollars are currently only disclosed in the fund's Statement of Additional Information or the adviser's semi-annual Form NSAR, filed with the SEC, and only available to fund investors upon request.

the execution of securities trades."[6] Robert C. Pozen, non-executive chairman of MFS Investment Management said, "We are asking Wall Street firms to give us an execution-only price…We are valuing their research at zero."[7] American Century urges Congress to seize this unique opportunity for soft dollar reform.

Prior to New York Attorney General Eliot Spitzer's activism, excess commissions were used to purchase Wall Street research that reportedly was an unfettered disinformation machine meant to promote "friends of the investment bank" and to attract new banking clients. Venture capital firms and CEOs of promising yet-to-be-public companies benefited from an option on the "hottest" new deals, according to the public record. Allotment of those "hot" deals to investment advisers depended, in large part, on the size of the commission flows through the investment bank's doors. Favorable research coverage of newly issued companies and the "star power" of the analyst assigned to cover the stock was an important consideration in choosing the underwriter of the company's public offering. Recent regulation and huge fines have impacted this behavior.

At the same time, the unique attributes of Wall Street's access to company management for an "inside" look at the company's prospects have vanished in the post-Regulation Fair Disclosure environment. Broker dealers used to be the

[6] March 2, 2004 letter from David Jones, Fidelity Management and Research, to SEC.

primary source of public company information. A company could not communicate in a timely or effective manner with all interested investors without the publishing power of Wall Street firms. Today, the internet allows virtually unlimited investor access to a company's quarterly earnings conference call. And the former insider advantage to Wall Street research has vanished with regulatory and technological advancement.[8] So, one should ask: Why are the rates for "research and services" so expensive as compared to the cost of basic execution? Execution only rates on some electronic brokerage platforms are less than 1c per share, and yet Wall Street still charges most investment advisers 5c per share (Exhibit 1).

How Big is the Soft Dollar Problem?

In its letter to the SEC, Fidelity estimated that the cost of investment research to fund investors approximates the fee equivalent of 4 to 5 basis points of mutual fund assets. However, research by Richard Strauss of Deutsche Bank estimates that only 45% of commissions pay for the execution of a trade; meaning 55% of the $12.7 billion paid in commissions in 2002 are used for Section 28(e) goods and services, including research and third party services. If that estimate is correct, then investors may be paying as

[7] March 16, 2004, "Mutual Fund Tells Wall Street it Wants A La Carte Commissions," NYTIMES.COM.

much as 15 basis points in extra undisclosed management fees. Money manager Whitney Tilson estimated in a recent column using this same data that investors pay about $6.3 billion in extra fees -- $21 for every man, woman and child in this country.[9] This is a huge hidden cost to investors.

[8] George Bodine, direct of trading for General Motors Asset Management, was quoted in the February 2004 Traders Magazine as saying that after Reg FD buyside traders no longer have to "direct business to specific brokers so we'd be a first call in the event their top analyst was changing his opinion." p. 40.
[9] See Appendix B, "The Disgrace of Soft Dollars," Whitney Tilson, March 19, 2004, The Motley Fool.

So, How Do Some Money Managers Use the Safe Harbor?

American Century and others have long urged regulators and legislators to shine a bright light on burgeoning industry use of the Section 28(e) safe harbor. [10] A 1975 Amendment to the Securities Exchange Act allows investors to "pay up" for research services that benefit the investor, in the best judgment of the investment manager. Subsequent SEC interpretations of what constitutes "research" under Section 28(e) have expanded the safe harbor's use.

Soft dollars may be "negotiated" in a number of ways. Some companies and clients prefer commission recapture programs whereby a broker will return 1c or so of "extra commissions" by check to investment managers and clients. If this occurred in the construction industry, it would be called a "kickback", but curiously in the investment management industry, it's called using the "safe harbor." To avail themselves of the safe harbor, other brokers and clients use so-called soft dollar converters who promise to pay $1,000 of the investment manager's expenses for every $1,600 of commissions directed to that broker, consistent with expectations of best execution. Most of these arrangements are not recorded on paper. Tax practitioners

[10] A 1989 Trader Forum bulletin quotes former SEC Director of Market Regulation Lee Pickard as saying; "There was some controversy at that time as to whether 28(e) should have been put on the books. There were people then, perceptive perhaps, who realized 28(e) was going to result in some abuses. But it's part of the law. The SEC can't change it by itself." **Institutional Investor**, "*The Gray Areas of Directed Commission,*" 1989, p. 3.

have suggested that written contracts might trigger a requirement for accounting treatment of soft dollars by investment advisers.[11] Currently, accounting literature does not count soft dollars as either income or expense on a manager's income statement because the value of those services is described as difficult to ascertain. One accounting manager described this practice to us as not unlike "off balance sheet accounting."

Two examples highlight how an investment adviser might employ the safe harbor to defray operating expenses in today's market environment.

Last year, American Century investigated new technology systems that would link portfolio management research databases to trading and back office systems. Leading competitors were invited to "pitch" their services, capabilities and costs. Sophisticated systems like this can carry price tags in the millions of dollars. Based on their experience with many other investment managers, the vendors competing for our business assumed we would want to "soft" the service. The installation of a $2 million system could be paid over a couple of years for $3.2 million in commissions – a drop in our $140 million commission bucket. They expressed surprise at our longstanding position on the appropriate use of our investors' commissions. It was clear

[11] While not "officially" on paper, virtually all investment adviser trading desks keep and maintain complete spreadsheet billing systems to make sure that investment adviser commitments are kept to vendors – and most receive a complete accounting from the soft dollar converters on whom they rely.

to us that "softing" was a customary part of their sales pitch and common means of payment for their services within the industry. In a soft dollar environment, there is no incentive to negotiate lower costs of service to the detriment of investors.

Second, Mr. Tilson tells the tale in his commentary of a search for office space in Manhattan[12]. He says a good setup for a four to five man shop might cost $10,000 each month - a big cost for a small money manager. He says he can reduce that cost by half if he does sufficient full brokerage commissions with certain firms that have office space available. It works this way. If he pays six cents per share for every trade, rather than the two cents he might otherwise pay, the broker pockets the extra four cents. If he buys or sells only 125,000 shares of stock every month with that broker, the extra four cents adds up to $5,000, which the broker returns via a break in the rent. At American Century, we trade more than 1 million shares almost every day. Obviously, Mr. Tilson and American Century forego significant profits by avoiding soft dollar arrangements and adhering to the principle that soft dollars are not fair to investors who already pay a negotiated management fee.

<u>Research Costs Six Times More Than Execution-Only</u>

[12] See Appendix B.

Last year, American Century traders executed approximately 55% of U.S. equity trading volume through various electronic, execution-only facilities at an average cost of about .85c per share. The average industry commission rate remains between 5.1c and 5.5c per share, according to Greenwich Associates. (Exhibit 1) That effective rate has changed little since 1991 despite a six-fold increase in trading volume because lower commission rates imply lower profits for both institutional money managers and their partners in the brokerage business. (Exhibit 2)

A reading of the legislative background of section 28(e) suggests that it was intended to keep fund managers out of regulatory hot water if they paid more than the lowest prevailing commission rate for services. But that was a different time. Industry practitioners feared that deregulated commissions would force a race to the bottom in price.

Recent reports indicate that while the average commission rate in cents per share has dropped marginally, commission costs have increased as a percent of total dollars (principal amount) traded.[13] The U.S. and Canada are the only marketplaces in the world that do not use percent of principal as a trading cost barometer. In U.S. trading, during periods of falling equity prices, fixed costs per

[13] Capital Research Associates report to American Century as of 12/31/2002.

share represent a higher portion of trading costs. In markets with rising prices, brokers encourage publicly traded companies to split their shares - effectively doubling the cost of trading for the same dollar amount of the company when fixed costs per share are used. There is no incentive for this kind of behavior in markets where commissions are calculated as a percent of the principal amount traded.

Commission rates, measured in cents per share, have moved very little since 1986 when the SEC liberalized its interpretation of research under section 28(e). Now the pool of equity trading volumes eligible for soft dollar use is expanding. At the end of 2001, the SEC expanded its interpretation of the safe harbor to cover "flat" risk less principal trades by market makers in NASDAQ securities. This action reversed a longstanding SEC position that such trades fell outside provisions of section 28(e). Decimalization and electronic networks have pushed most of Wall Street away from principal market making in NASDAQ securities. As brokerage firms move to an explicit commission-based system for NASDAQ stocks, investment managers will likely access this new pool of available dollars for still more research and services.

We now have the systems and the data to create meaningful disclosures of these costs to investors. At best, insufficient disclosure provides investment managers little incentive to rationalize and manage the commissions, which are paid directly by investors. At its worst, section

28(e) allows some managers to boost profits during bad market conditions by paying more bills with investor commissions (Exhibit 3). Greenwich Associates reported that a 27% decline in assets under management for the typical institutional manager in 2001 sharply reduced management fee income. Investment managers responded to the decline in assets, in part, by boosting soft dollar amounts paid by 17%, according to the self-reported study.[14]

What Is Best Execution?

The Section 28(e) safe harbor has been predicated on the notion that an investment adviser can pay up "when consistent with best execution." Assumption of "best execution" appears just about everywhere: due diligence manuals, marketing presentations, consultant questionnaires, and requests for proposals. But no legal definition currently exists. Thus, the search for best execution has proven elusive despite the many assurances otherwise. "We know it when we see it, but it is really hard to measure," is an oft-quoted expression on trading desks when alluding to the concept of best execution. In some environments, traders are not paid to make decisions that really work to achieve best execution and have disincentives to doing so. They have soft dollar chits to pay and shares waiting to trade for impatient, demanding, and often unrealistic portfolio managers. Traders operate under

[14] **Greenwich Associates**, *A Closer Focus on Trading Costs*, April 2002

what I call "maximum risk aversion for maximum pay on the desk." As a portfolio manager, when I made a bad decision, I blamed the trading desk. Trading is a function in which it is difficult to claim "value added" and easy to look bad in a handful of trades. As a result, it is no surprise that traders give the ambivalent answers they do when asked about best execution. Traders do not often confess that directed commissions might put best execution at risk - that would instead put the adviser's ability to attract new clients and ultimately, the company's profitability at risk instead. [15]

[15] Chris Orndorff, managing principal of Payden & Rygel Investment Management, Los Angeles was quoted in the February issue of Traders Magazine saying: "Getting rid of soft dollars would be one of the best things that could happen in the relationship between traders and portfolio managers…Then you'd have trader truly trying to make the best execution, rather than seeking best execution and at yet at the same time knowing they must feed the soft dollar broker" noting that these are typically contradictory efforts.

New Definitions of Best Execution

In 2000, before leaving the SEC, former Chairman Arthur Levitt started the process of articulating new standards for best execution. At the same time, both the Investment Company Institute (ICI) and AIMR were asked to convene best practices groups to help define best execution. At the December 2000 ICI Securities Law Development Conference, Gene Gohlke, associate director of the SEC Office of Compliance Inspections and Examinations, offered this definition of best execution:

> *"In placing a trade, the trading desk will seek to find a broker/dealer or alternative trading system that will execute a trade in a way that the trader believes will realize the maximum value of the investment decision."*

Given the conventional wisdom surrounding best execution, this definition presents a challenge to the industry. The "investment decision" referred to in Gohlke's definition pertains to <u>the particular trade being executed</u>—not to yesterday's research from some broker dealer or consultant who directs a lot of business to the firm. In terms of words, the change is minor, but in terms of policy, the change is substantial. And the addition of "alternative trading systems" in the definition is a big change. The use of electronic communication networks (ECNs) and nontraditional trading systems has expanded dramatically during the past 10 years. Yet, on the buy side, institutional money managers still directly use these systems less than 7-

8 percent of the time. [16] Recognizing that trading cost reductions directly boost investor returns, at American Century we use lower cost electronic brokers for approximately 55% of our U.S. equity trades.

In his presentation at the ICI Conference, Gohlke identified possible areas in which SEC auditors will spend more time. Investment managers have fiduciary obligations to boards as well as to investors in the areas of compliance systems, compliance evaluation procedures, and record keeping. Congress should ask the SEC to continue down this path by reviewing the business practices of investment advisers to achieve best execution, including:

- Adequacy of order-handling systems
- Trade error experience
- Timeliness of execution reports
- Allotment of initial public offering (IPO) shares against requested allocations
- Use of ECNs as a low cost execution-only vehicle for investors

AIMR Trade Management Guidelines

[16] Paula Peter, manager of equity trading at Mello Private Wealth Management, was quoted in the February 2004 Traders Magazine as saying that the elimination or scaling back of soft dollars would provide traders more discretion over order flow. "Then we wouldn't have to trade with particular brokers…We would more actively pursue alternative sources of execution, controlling more of the execution on our desk." p. 38.

AIMR's proposed Trade Management Guidelines on best execution were announced in November 2002.[17] The AIMR recommendations are consistent with the direction of the SEC. The guidelines recommend the establishment of trade management oversight committees that will be responsible for developing a trade management policy and a process to manage the efficacy of trades. Are you getting what you are paying for? Are you evaluating the service you received? And are you evaluating the providers of that service? Specifically, the implications of these guidelines are as follows:

- Substantial infrastructure spending will occur to build record-keeping and reporting systems to track and audit trading information appropriately because so many firms still operate with inadequate order management systems.
- The negotiation of acceptable commission ranges and documentation of the variance between negotiated and actual commission rates will become necessary. Commission rates that held at 5-6 cents a share for more than a decade should and will be negotiated down to a level closer to the 1.00-1.25 cents a share rate paid on ECNs for execution-only services.
- Trade management oversight committees will be established, and the internal documents prepared for these committees will be auditable by the SEC.

[17]The guidelines are available at www.aimr.org.

- Real and potential conflicts of interest must be documented.
- The choice of a particular trading system must be supported, and the review and evaluation of trades, broker selection, and execution performance can be expected.

What Are Soft Dollars Really Buying?

In Gohlke's definition of best execution, traders are charged with maximizing the value of the trade decision. But Robert Schwartz, the Marvin M. Speiser Professor of Finance at Baruch College, City University of New York, and Benn Steil, at the Council of Foreign Investors, have studied how little control traders actually have over the execution decision. They sent questionnaires to the chief investment officers of major investment companies that asked, "Who at your firm controls institutional commission payments?" They found that 62 percent of all trades are not controlled by traders.[18] (This finding is consistent with my experience as a trader and portfolio manager.) The report also addresses how often commissions are used to pay for things other than best execution. And Steil, aggregating information from a variety of reports on commission bundling, has stated that nearly two-thirds of soft dollar agreements are unwritten and

[18]Robert Schwartz and Benn Steil, "Controlling Institutional Trading Costs," *Journal of Portfolio Management* (Spring 2002):39–49.

more than one-third of brokers are a party to illegal soft dollar arrangements.[19] Clearly, soft dollar agreements play an important role in the execution decision and are often in direct conflict with an investment firm's fiduciary duty to the client.

In his speech to the Securities Industry Association in November 2000, SEC Chairman Levitt asked whether portfolio managers were bringing to bear the pressure they should on brokerage commission rates and why the emergence of electronic markets had not driven full-service commissions lower. If a trade on an ECN costs a penny or less a share, why do most people on the buy side still pay 5-6 cents a share? Do portfolio managers and independent directors think 6 cents is safe, that it falls within the safe harbor exception of Section 28(e)?

Levitt warned then that 6 cents was not a safe rate. And yet there appears to be no evidence to date that the Commission has done more than use a bully pulpit - the Commission requires the help of the Congress to fix this problem.

I once was convinced that the more business American Century executed on ECNs, the more our market impact costs would rise because of a structural reversion to the mean. **Table 1** illustrates, however, that the mean for all-in

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[19]Benn Steil, "Can Best Execution Be Achieved in the Current Market Structure?" Presentation given at the AIMR conference "Improving Portfolio Performance through Best Execution," November 30–December 1, 2000, Chicago.

trading costs is down, not up. As our business on these nontraditional systems increases, our overall efficacy, as measured against other brokers doing similar business in the same time frame, has widened. This means that the total cost of trades in anonymous, electronic venues - both the commissions and market impact -- are far more effective than with brokers and traditional exchanges. Such systems remove structural, intermediated costs. The nontraditional players, highlighted in bold in Table 1, are important; in particular, B-Trade, Archipelago, and Instinet have lowered our costs of trading. Broker 3, one of the most respected Nasdaq market-making firms in the business, produced costs equal to 2.03 percent of principal, round-trip, on Nasdaq trades, whereas Archipelago and Instinet both produced a negative cost. According to Capital Research Associates' methodology, "negative cost" means that the day after our order is finished, the price of the stock we sold is still falling. In other words, we have not telegraphed our intentions to the rest of the market in moving big orders, and we have succeeded in executing at a relatively fair price.

Use of electronic trading for listed stocks has only recently begun to accelerate; Archipelago linked into the Nasdaq system to display orders in the public market early in 2001. Traders can now put their order indications into the public quote system and split the spreads charged by the

specialists. The ability to lower costs this way is compelling.

Table 1.Capital Research Associates' Study of ACIM All-In Trading Costs

Broker	Dollars Traded	Average Market Cap (billions)	Average Volatility	Cost as Percentage of Principal	
				OTC	Listed
ACIM funds average	$47,607,820,875	$56.76	51%	0.49 bps	0.32 bps
Broker 1	4,263,056,375	48.67	45	0.66	0.28
Broker 2	2,637,630,000	47.28	45	0.93	0.23
Broker 3	1,672,943,750	42.69	56	2.03	0.40
Broker 4 (a)	1,738,325,000	35.23	51	1.00	0.24
Instinet	2,219,195,000	61.35	61	0.23	2.72
Crossing Network	923,983,750	45.17	53	0.61	0.25
B-Trade	3,697,211,250	56.24	63	0.84	0.28
Archipelago	5,855,745,250	65.83	64	0.06	0.46
Traditional brokers (b)	10,311,955,125	43.47	49	0.66	0.09
Electronic brokers	12,696,135,250	57.15	60	0.29	0.93

Note: Data reflect non-dollar-weighted mean of 10 six-month periods, June 30, 1997, through June 30, 2001 (post-order-handling rules).

a Negative OTC costs are a function of aftermarket IPO performance.

b The "traditional brokers" category reflects four large brokers only.

Market Stability

For decades, brokers have justified all types of structural cross-subsidies by claiming that when markets are under stress, the broker will help stabilize the market. The popular theory was that the ability to get best execution depends on a broker's willingness to lay capital on the line during times of market distress, when that capital infusion is really needed. In their article, Schwartz and Steil conclude, instead, that the buy-side institutions' call on street capital for immediacy of execution is an insurance or option to protect the investment manager's identity and order size from being captured by intermediaries and transmitted to competitors—to avoid being front-run. To support this contention, Schwartz and Steil point out that, based on the responses to their survey, portfolio managers rarely create orders based on seeing the other side through a telephone call, trading activity, or order flow in the market. Investment managers appear to be attributing their willingness to pay up for liquidity to a reason that is not borne out in practice. Recent, well-publicized regulatory actions and huge fines against NYSE specialist firms further augment these arguments and remove the notion that brokers and specialists stand prepared to lose money for investors during difficult market environments. The violations committed by the specialist firms occurred during the worst

three year market environment since the Great Depression. If those weren't bad times, I'm afraid to consider the alternative.

A History of Worries About 28(e) and Investor Interests

It is interesting to review the regulatory history of section 28(e). The topic has been revisited often since 1975. Original interpretations of the statute by the Securities Exchange Commission did not permit a "safe harbor" for commissions used to purchase services "customarily available to the general public."[20] In 1986, after intense industry pressure, the SEC allowed that an investment advisor could use commissions and "pay up" for any service that assists him in making investment decisions on behalf of his clients.

Austin George, then head trader at T. Rowe Price, was quoted in 1989 as saying:

> "And, then of course, what's happening is people are starting to work backwards through all those things that for years were ordinary and expected business expenses to see how they could recover their costs. This is my personal area of greatest concern - in terms of the industry, not T. Rowe Price - because you suddenly put the trader in the position of being a potential deterrent to enhancing the profitability of the firm."[21]

The SEC subsequently reopened debate on aspects of section 28(e) with the concept release called Market 2000, in 1992. The House Subcommittee on Telecommunications and

[20] **Institutional Investor**, *The Gray Areas of Directed Commissions*, 1989, p. 4.

Finance held hearings on this matter in July 1993. David Silfen, a Goldman Sachs partner, testified:

"[C]onflicts of interest are inherent in soft dollar arrangements. The money manager receives the products and services paid for by soft dollars. The client, often unknowingly, pays for these products and services as part of the brokerage commissions charged to his account. This situation presents an obvious temptation to the manager to buy items that benefit itself rather than the client, or items, such as general research reports, quotations services and computer hardware and software, that other managers consider their own responsibility under their basis management fee. The money manager may also pay too much in commission or engage in unnecessary trading so as to generate more commission and thus more soft dollars."[22]

The possible misuse of commission dollars received additional SEC scrutiny in 1998 during a well-publicized soft dollar "sweep" during which broker dealers were audited for possible abuses.

Again and again, rightly placed concerns have foundered on the inadequacy of audit trails, the unrecorded nature of many soft dollar arrangements and the mutual benefit derived by industry players who work to preserve the opacity of the payment system.[23] [24]

Congress or the SEC should mandate record keeping requirements for soft dollar transactions.

[21] **Institutional Investor**, *The Gray Areas of Directed Commissions*, 1989, p. 8.
[22] Oral Testimony of David Silfen, partner, Goldman Sachs and Co., July 12, 1993, House Telecommunications and Finance Subcommittee
[23] Nearly two-thirds of soft dollar agreements are unwritten and more than one-third of brokers are a party to illegal soft dollar arrangements, Benn Steil, *"Can Best Execution be Achieved in the Current Market Structure?"* AIMR Conference, December 1, 2000
[24] A check with our auditor determined that funds do not record income or expense from soft dollar practices because of the difficulty in assigning a value to research services and because of the undocumented nature of most agreements.

In 1975 when the soft dollar safe harbor was born, the idea of "paying up" was an abstract notion. Personal computers didn't appear until 1982. Complex networks, commercial adoption of the Internet, and central data repositories were all a decade or more away. Today, the execution only cost of trading is readily identifiable and should be reportable to support soft dollar disclosure and oversight.

Commissions, Accounting Bills, Phones and Exchange Fees

A major wirehouse-sponsored soft dollar broker who "converts" investor commissions into bill-paying arrangements could pay 264 third party "research" providers/vendors in 1988. In 1994, that same broker had bill-paying relationships with 573 vendors. ***Today, the list has grown to more than 1,200 service suppliers*** (Exhibit 4).

Accounting firms Ernst & Young and PricewaterhouseCoopers now can be paid with soft dollars.[25] Telephone companies such as SBC Corp. can be paid with commissions. Professional development programs at the Kellogg School of Management and the Wharton School can be financed with commission streams. Recruiting firm Kforce.com is on the list. So are Compaq, Dell and CompUSA. The Standard Club of Chicago, "a private retreat of luxury and tranquility…home to Chicago's fashionable society and the

[25] See Exhibit 4, approved vendor relationships with major wirehouse soft dollar broker.

business elite for over 125 years,"[26] also appears as a destination for some commission dollars.

An investment manager requires a phone, a newspaper and a stock quotation service to open his doors and to manage money. Is the management fee intended to pay only the management salaries of the investment company? We think not. Without specific regulatory action from the SEC and Congress that compels better disclosure and assignment of the economic value of this undisclosed income stream, more and more costs of business may soon fit the elusive and ever-expanding definitional framework of "research" under section 28(e).

SEC staff members have explained to me that definitions of best execution and research are so vague as to defy enforcement action. Recent attempts to define best execution "best practices," such as the Association for Investment Management and Research (AIMR) guidelines, have been watered down by qualified language offered by those with compelling commercial self-interests. Congress needs to stop the stalling.

Conclusion

As an investment manager, my experience is that good thinking by brokerage firm analysts is often invaluable in making wise investment decisions for my investors, especially in the universe of "under-followed" small companies. As an

[26] Quote from Standard Club website.

equity trader, I know that brokers can critically augment our execution capabilities by facilitating block trades and by supplementing our internal trading resources during periods of heavy trading activity. The brokerage industry provides valuable service to mutual fund advisors and other investment managers. However, our industry has failed thus far to adequately measure and report on the cost of these services to investors. The structural profit incentives of current practices will not change without the intervention of Congress to better define and limit the scope of section 28(e). For these reasons, and with the interests of investors foremost in mind, we offer the forgoing recommendations and discussion.

Thank you for the opportunity to share my ideas on behalf of American Century and its investors.

Exhibit 1

What Does "Paying Up" Mean

Imputed Cost of Research in 2002

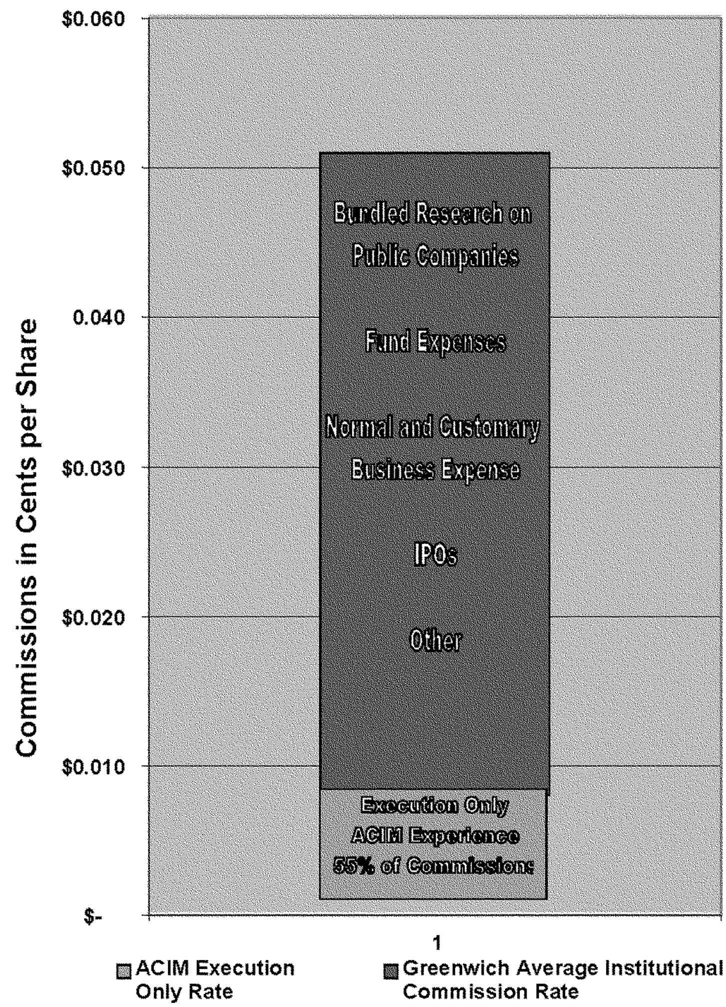

Exhibit 2

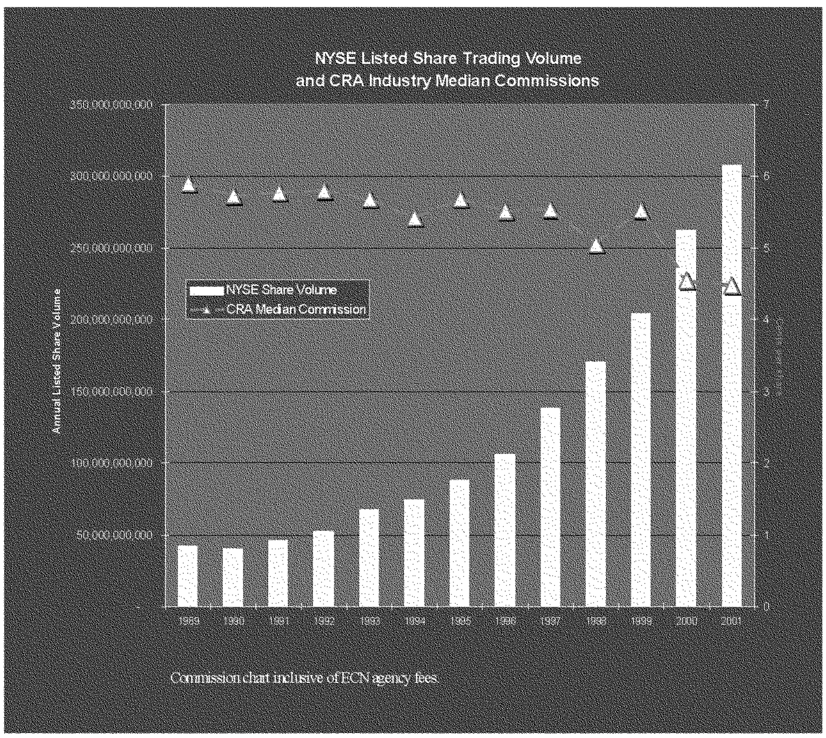
NYSE Listed Share Trading Volume
and CRA Industry Median Commissions
Annual Listed Share Volume
350,000,000,000
300,000,000,000
250,000,000,000
200,000,000,000
150,000,000,000
100,000,000,000
50,000,000,000
NYSE Share Volume
CRA Median Commission
1989
1990
1991
1992
1993
1994
1995
1996
1997
1998
1999
2000
2001
7
6
5
4
3
2
1
0
Commission chart inclusive of ECN agency fees.

Exhibit 3

Impact of 28(e) on Management Company Earnings
Who Would You Rather Be?

Investor Invests $100,000 in Fund with 1% Management Fee and Pays All Commissions

Investment Company A Collects $1,000

Company A pays the following bills with cash as part of normal and customary business expense

Revenues	**$1,000**
• **Salaries/Benefits**	**400**
• **Computer Hdwr & Telecom**	**250**
• **Marketing & Distribution Activities**	
• **Exchange Fees**	
• **Wall Street Journal**	
• **Trade Association Dues**	
• **Proxy Voting Services**	
• **Printing & Annual Report Prep**	**150**
(Services Otherwise Available for Cash)	
Profit	**$ 200**

Margin 20%

Commissions paid consider only best execution – at lowest possible commission.

Investment Company B Collects $1,000

Company B pays the same bills under 28(e) because of a manager's good faith determination that the service will benefit investors.

Revenues	**$1,000**
• **Salaries/Benefits**	**400**
• **Marketing & Distribution Activities**	**300**
Profit	**$ 300**

Margin 30%

Company B negotiates a rate for services – not usually in writing – that generates commissions sufficient for a broker to pay "manage money" bills and make a profit. Typically $1,600 in commissions pays $1,000 in bills.

Company B directs 35% of commission business to specific brokers – realizes dramatic earnings improvement with little incentive to rationalize expense.

Company B Benefits and the Investor Pays

Exhibit 4

Leading Soft Dollar "Converter"
About 1,200 Vendors

Acadia Research Group
Accent Systems, Inc.
A.G. Bisset & Co., Inc.
American Health Consultants
ACNeilsen
Acromedia Systems, Inc.
Active Graphics
ADP Investor Communication Services
Advantage Data Inc
Agra Europe (London) Ltd
Airco Mechanical Inc.
Alan Reynolds Associates
Alliance Capital Management, LP
Alliance-Ibbotson Research Institute
Alliance of Healthcare Advisors
Allied Riser Operations Corporation
Allmerica Financial
Alpha Enterprises International
American Express Financial Advisors
American Skandia Investors Services, Inc.
American Stock Exchange
Ameritech
AMG Data Services
AMR Research
Analytic Systems Corp.
Anari Incorporated
ANB Investment Management
Annuity Price Center
Arbor Trading Group Inc.
Argus Research Corporation
Aristadata, Inc.
Armstrong Teasdale, LLC
APT Partners
Ark Asset Management Co., Inc.
Arrow Group
ASG Companies
Asia Society (The)
Asian Wall Street Journal (The)
Asia Pacific Communications Limited
Aspen Publishers, Inc.
Aspen Research Group, Ltd.
Asset Performance Partners
Asset Strategy Consulting
Associated Investment Services
Astro Office Products, Inc.
Atec Group
A-T Financial Information Inc.
Atlantic Group FPPM, Inc.
Atlanta Journal and Constitution, The
Attronics
Autex Group
Automotive News
Avalon Research
Avenue Technologies
Aviation Week Group
Axiometrics Inc.
B/C Computing, Inc.
Banc of America Securities
Bader Computer
BAMAR Enterprises Inc.
Bank of America
Bankers Trust Company-NY
Bargerhuff & Associates, Inc.
BARRA International
Barron's
Barrow Hanley Mewhinney
Baseline
BB&T Capital Markets
BCA Publications
Becker Vanetten, Inc.
Behavioral Economics, Inc.
Benderly Economic Associates
Berge Consulting Group
Berkeley Program in Finance
Big Dough.com
Billings Research
Biopharma Consulting Group
Bioscience Securities
Birinyi Associates Inc.
BIRR Portfolio Analysis, Inc.
BITS Inc.
Black Box Network Services
Blakeney Management
Blitz Computer
Bloomberg, LP
Bloombury Minerals Economics Ltd.
Blue Chip Growth Letter
Blue Heron Consulting
Bobbi Trading Corporation
Bogdan Computer Services, Inc.
Bond Buyer, The
Bond Investor Newsletter (The)
Bond Market Semiotics
Bonneville Market Information
Book Industry Study Group

Boston Capital Markets Group, Inc.
Boston Company Asset Management, Inc., The
Boston Energy Research
Boston Safe Deposit & Trust Co.
Boyd Watterson Asset Management LLC
Bowne of Chicago, Inc.
Boxalls
BPS Consulting Services
Brandywine Asset Management, Inc.
Breaking Views
Brean Murray & Co., Inc.
Bridge Japan Inc.
Bridgewater Associates
Brinson Partners, Inc.
British American
Brookside Corporation
BSP Solutions
BT North America
Buck Consultants
Bulls Eye Research
Burgiss Group (The)
Business Cycle Perspectives Inc.
Business Intelligence Advisors
Business Research Publications
BuzzCompany.com

C.S. McKee & Co., Inc.
Cabletron Systems
Cable Television Tokyo Ltd
Cableworx
Cadence Capital Management
Cadogan International Conferences Ltd
California Technology Stock Letter
Calamos Asset Management, Inc.
Calab Fund LP
Callan Asociates, Inc.
Cambridge Associates Inc.
Cambridge Energy Research Associates
Capital Analysts Network
Capital Hill Research
Capital Insights Group
Capital Management Sciences
Capital Market Publishers India Ltd.
Capital Reflections Inc.
Capital Resource Advisors
Capitol Publications Inc.
Carty Mailloux Consulting, Inc.
Cast Software, Inc.
CCBN.Com (Street Events)
C-Call.Com
CCH Washington Service Bureau Inc.
C.D. Crary & Co
CDrive Corp.
CDW
Center for Management Research, Inc.
Center for Research in Security Prices
Century Securities Associates Inc.
Charter Investment Group
Charter Research Corporation
Chaumont, Inc.
Check Free Corp-Investment
Chemical Institutional Asset Services
CHR Metals Limited
Cimino Associates
Citicorp-North America/Leasing Inc
Clarendon Marketing & Production
Clarsen Investment Research
Clydsedale Bank PLC
CML Market Letter Inc., The
Coach Comp America
Coleman/Bartlett's Washington Focus
Columbine Capital Services
Comerica Bank & Trust
Comline Business Data, Inc.
Commerce Bank of St. Louis
Commercial Estate Secondary Mkt.&Sec.
Commercial Property News
Commercial Real Estate
Commodity Accounting Systems
Commodity Metals Management Company
Commodity Trend Service Charts
Comp USA, Inc.
Compass Bank
Compaq Computer Corp.
Compaq Direct Plus
Complete Communications, Inc.
Comprehensive Computer Center
Compucom
Computer & Application Inc.
Computer Express, Inc.
Computer Merchants LTD
Computer Horizons Corporation
Computerwire, Inc.

Computerized Portfolio Mgmt
Services Inc
Commscan, L.L.C.
Comscore Networks
Comtrade
Condor Advisers
Consensus Economics Inc.
Consolidated Natural Gas Company
Container Consulting
Containerisation International
Contravisory Research Corp.
Convergent Media Systems Corp.
Conway Pedersen Economics, Inc.
Corestates Bank
Cornerstone Peripherals Technology
Corporate Access/Condor
Cortex A[[lied Research Inc
Cost Effective Measurement Inc
CotLook Ltd.
Council of the Americas
Covato Research Corporation
Cramer Rosenthal McGlynn, LLC.
Crandall Pierce and Company
Credit Sights
CrossBorder Capital
Crowley Micrographics, Inc.
CSK
CRU International LTD
CTC Illinois Trust Company
CTS Financial Publishing
Customized Data Systems, Inc.
Cutler and Company, Inc.
CWR Computer Consultation

DAC Easy Software, Inc.
Daily Deal, The
Daily Variety
Dallah Media Productions
Dalton, Greiman, Hartman, Maher &
Co
Dan Royer & Co.
Daniel Morton & Company, Inc.
Darwin Partners, Inc.
Data Broadcasting Corporation
Data Comm Warehouse
Data Transmission Network
Corporation
Datastream International Ltd.
Dataware Solutions
Davis, Mendel & Regenstein, Inc.
Decision Software, Inc.
Dell Direct Sales Corporation
Dell Quotation
Dell'Oro Group
Denver Gold Group
Depository Trust Company, The
DePrince, Race & Zollo
Derivative Solutions
Des Plains Office Equipment
Company
DeScenza & Co., Inc.
Detroyat Associates, Inc.
Dial Data
DiBiasio & Edgington, Inc.
Directv
Disclosure Incorporated
Docupro
Dodge & Cox
Dollarlink Software
Dorsey, Wright & Associates, Inc.
Dow Jones Financial Publishing, Co..
Dow Jones Markets, Inc.
Dowling & Partners Securities, LLC
DPC Data Inc.
Duff & Phelps Credit Rating Co.
Dunedin Fund Managers Ltd
Dympna Clarke
Dynamic Traders Group, Inc.

Eagle Development Group
Ebsco Subscription Services
Eclipse Computer Systems, Inc.
Econoclast, The
Economatica
Economic Analysis Associates, Inc.
Economic Cycle Research Institute,
Inc.
Economics from Washington
Economist, The
Edgar Online
Edward Walter Design
EEI Effron Enterprises, Inc.
EFM Technical Research Limited
Egan-Jones Ratings Company
EGS Securities
Electric Power Daily
Electric Utility Week
Eliassen Group, Inc.
Elliott Wave International
Elkins & McSherry Co. Inc.
Emap Business Communications
Emery Consulting Services

Empire Group LLC
Energy Argus
Engineering News-Record (McGraw-Hill Cos.)
Ennis Knupp & Associates
Enteract Corp.
Enterprise Communications
Entex Information Services, Inc.
Equant Resources
Equity Research Associates
Ernst & Young LLP
Estima
Euromonitor International, Inc.
Eurohedge
European Investors
European Private Equity & Venture Capital
Evans-Novak Political Report
Exabyte Corporation
Excalibur Management Corporation
Excite@Home
Eze Castle Integration, Inc.

F-D-C Reports, Inc.
Fair Disclosure Financial Network
FAME Information Services
Farallon Capital Management, LLC
Farrell Advisory Associates, LLC
Faxon Company, The
Federal Filings Inc.
Federal Reserve Bank of Boston
FICOMP, Inc.
Fidelity Management Trust Company
Financial Control Systems Incorporated
Financial Information Services
Financial Planning Resources
Finucane, J.W. Financial Consulting
First Data Investor Services Group, Inc.
First Equity Corporation of Florida
First Interstate Bank of California
First Pacific Advisors, Inc.
First Source International Inc.
First Union
Fitch Investors Service
Fleet Bank of MA
Fleischman Richard & Associates
FMH Investments, LC
Forbes
Ford Investor Services
Formprint
Formula Research
Foundation for Intl Business & Eco. Res.
Fourteen Research Corporation
Franklin Research's Insight
Fraser Management Associates
Free Market Inc.
Freedom Capital Management Corporation
FRI Corporation
Front Line Systems
Frontier Analytics, Incorporated
FTSE International Limited
Future Source
Future Data Systems Inc.
Futures Magazine Group
Futures Trading Center

G A T Integrated Financial Services
G. A. Clarke & Associates, Inc.
G7 Goup, Inc.
Gabriel, Roeder, Smith & Company
Galaxy Consultancy Limited
Gann, AWD Treasure Discovered
Gancarz Software Consultants
GARP Research Company
Gartner Group
Garzarelli Outlook, The
Gateway 2000
Gateway Companies
Gateway ShopStop.Com
GE Capital Information Technology
GE Information Services Inc.
Gerson Lehrman Group
Giga Information Group, Inc.
Gilder Publishing
Gilder Technology Report
Gimme Credit Publications Inc.
Glenmede Trust Company
Global Advanced Technology Corp.
Global Information Resources, Inc.
Global Investment Research, Inc.
Global Investor Publishing
Global Market Consultants, Ltd.
Global Network (The)
Global Technology Consulting, Inc.
Global Technologies, Inc.
Global Trend Alert
Gold Stock Analyst
Golden Star Technology/Micro City

Goldman Sachs Asset Management
Gordian Institute
Gordon, Haskett & Company
Gorham Advanced Materials Institute
Grant's
Green Tree Vendor Services Corp
Greenhill
GRI Companies
Grotevant Walker Research Ptners.
Group of Thirty
Gylmesi & Wedinger P.C.

H. Buff Herr
H. Clark & Company Limited
HC Instanbul
HSBC Broking (Data Service) Ltd.
Haimovilch Medical Technology Company
Hammer Consulting Group, The
Hanner Consulting Group (The)
Hanson, Perry & Jensen, PA
Harris Corp. Digital Telephone System
Harris Investment Management
Harris Trust and Savings Bank
Harry Hansen Management, Inc.
Helix Investment Partners, LP
Hellenbrand Consulting, LLC
Hewitt Associates
High Frequency Economics, LTD.
HK Ventures
HKC Securities
HLH/Panoramic
Holt Value Associates
Hood Company (The)
Horace W. Brocking Consulting
Howe Barnes Investments
HSBC Bank USA
Hub Data, Inc.
Hueler Analytics
Hughes Design/Communications
Huntington Investment Company

I.D.E.A. Incorporated
I/B/E/S International, Inc.
Ibbotson Associates, Inc.
IBCA Limited
IC Insights, Inc.
ICM Conferences
ICMS International
IDC Portfolio Management Inc.
IDS Advisory Group, Inc.
Imark Communications, Inc.
Imprima Management Services Inc.
IMS America, Ltd.
IMI Systems Inc.
IMS Health, Inc.
Inacom Information Systems
Income Research & Management, Inc.
Independent Investor Digest
Independent Perspectives
Independent Professional Services
Independent Strategy
Indepth Data Inc.
Industrial Contractor, Inc.
Infinity (A Sunguard Company)
Info USA Marketing Inc.
Information Management Network
Information USA Marketing Inc.
Information Resources Inc.
Informix Software, Inc.
Info-Reach, Inc.
Infoshare Communications, Inc.
Infosys Technologies Limited
Infotech
ING Baring Furman Selz, LLC
Ingalls & Snyders LLC
Innotech Solutions, LLC.
Inside Mortgage Finance Publications
Inside Radio
Insight
Insight Capital Management, Inc.
Institute for International Economics
Institute for International Research, The
Institute of International Finance
Institute for Private Investors
Institutional Capital
Institutional Investor Services
Institutional Property Consultants, Inc.
Institutional Real Estate, Inc.
Institutional Research Services, Inc.
Institutional Shareholder Services
Institutional View (The)
Insurance Forum (The)
Interactive Data
Intergrated Circuit Engineering Corp.
Inter-Logic Associates, Inc.
International Capital Market Corp.

International Cement Review
International Data Corp.
International Data Corp., Asia/Pacific
International Finance Corporation
International Forecasting
International Fund Administration
International Management Services
International Monetary Fund
Internet Network Technologies
Internet Systems Design Group, Inc.
Intersec Research Corporation
Intersoft Corporation
Interstudy Publications
Intex Solutions, Inc.
Intraspect Software
Investec, Inc.
Investek, Inc.
Investment Advisers, Inc.
Investment Analytics
Investment Company Institute
Investment Counsel Association of America
Investment Data Corporation
Investment Dealers' Digest, Inc.
Investment Research Institute
Investor Economics Inc.
Investors Bank and Trust Company
Investors Business Daily
Invesco, Inc.
InvestWorks
Ista Mielke GMBH
IPC Information Systems, Inc.
IPL Technologies, LTD.
IPO Financial Network
Ira Sohn Investment Res. Conf.
J. Glass & Associates
JG Kilan Company
J.L. Kellogg Graduate School of Management
Jag Notes
Jerome Levy Forecasting Center
JM Cannell, Inc.
JMA Research Institute Inc
JMR/Financial, Inc.
John Wiley & Sons
Johnson Custom Strategies, Inc.
Johnson Rice & Company LLC
Jolson Merchants Partners
Jos Technology Inc.
Joseph DeCosimo and Company
Journal of Finance (The)
Journal Watch
J.P. Morgan Investment Management
JT Sorrells Inc
Jupiter Media Metrix
J.W. Finance Consulting

Kagan World Media
Kaufman Brothers, LP
KEA Capital
Keane Inc
Kforce.com
KMI Corporation
Kenny Information Services
Kenwood Group, Inc.
Kestrel Technologies, L.L.C.
Kilpatrick Stockton LLP
Kinder, Lydenberg & Domini, Inc.
King & Spalding
Kingsley Associates
Kinsley Power Systems
Kirkpatrick and Company
KLD Research & Analytics Inc
KMI Corporation
Knight-Ridder Information, Inc.
Knobias.com
Kobren Insight Management, Inc
Koch Financial Corporation
K.P.A. Advisory Services

LaJolla Economics
Lamers Equity Research
Lande Group/Micro Computer Systems
Lark Research
LaSalle National Bank
Laurence H Meyer & Associates, Ltd
Lavery Consulting Group
Legg Mason Wood Walker, Inc.
Lehrman Bell Mueller Canon, Inc.
Leigh Bureau
Lend Lease Rosen
Leuthold Group, The
Lexis Document Services
Lexis/Nexis
Leylegian Investment Management, Inc.
Liebert Corporation
Lifeline Industries, Inc.
Little Black Box Forecasts
Line Data Services, Inc.
Lincoln Capital Management

Company
Lipper & Company. LP
Little Black Box Forecasts
Liscio Report (The)
Lloyd George Investment Management
LMC International, Ltd.
Loan Pricing Corporation
LongView Group (The)

M. Shanken Communications
MacKay-Shields Financial Corporation
Macro Computer Products, Inc.
Macroeconomic Advisers, LLC
Managed Account Reports
Manufacturing & Network Solutions
Market.com, The
Market News Service Incorporated
Market Profile Theorems, Inc.
Market Research Corporation
MarketNet Group
MarketSoft Research
Market Statistics
Market Systems Newsletter
MarketSoft Research
Market Trends Investors
Market Vane Corporation
Marquette Associates, Inc.
Marquette Financial Group
Marsico Capital Management, LLC
Martaus & Associates, Inc.
Martin Currie, Inc.
Marvin Zonis & Associates, Inc.
MBH Commodity Advisors Inc
McAffee Associates, Inc.
McCarthy, Crisanti & Maffei, Inc.
McCartney Construction Company
McClellan Financial Publications, Inc.
McDonald Investments
McDonnell Information Systems Limited
McSherry & Company
MCSI Computer Supplies
Measurisk .com
Mealey's Group, The
MediaOne
Medley Investment Group, LLC (The)
Megent Fis
Mehta Partners
Mellon Bank
Mellon Trust
Merritt Communications
Mesirow Financial
Meta Group Inc
Metal Bulletin Inc.
Metriplex, Inc.
Metropolitan West Asset Management
Metzler Services
MFS Telecom, Inc.
Michigan National Bank
Micro Design Resources
Microage Computer Stores
Microhedge, Inc.
Microland-Macroland "HQ"
MicroMedia Inc
Micron Electronics, Inc.
Micropoint Computers
Mi-Kro Computer World
Midas-Kapiti International
Middle East Economic Survey
Miller Anderson & Sherrerd, LLP
Millennium Investment Corporation
Milliman & Robertson, Inc.
Milken Institute Conference Center
Missing Link, The
Mitchell Hutchins Institutional Investors Inc.
Mitchinson Napier Bedford
ML Consulting Services
ML Trust of America
Mobile Plant
Modern Healthcare (Crain Communications)
Mondiale Partners, Ltd.
MoneyLine Network, Inc.
Money Manager Review
Money Market Directories, Inc.
Monis Software Limited
Montgomery Investment Technology
Montag & Caldwell, Inc.
Moody's Investors Services
Morgan Stanley Capital Intl Research
Morningstar, Inc.
Mosaic Research
MRL Trade Limited
MSNBC Desktop
MST Research, Inc.
Multex Systems, Inc.
Multichannel News
Municipal Emp. Rtmt. Sys. of

Michigan
Municipal Market Advisors
Municipal Market Data
Municipal Treasurers' Association
Murex North America, Inc.
Murenove Inc.
Muzea Insider Consulting Services

NAA Foundation
NAIC Securities Valuation Office
Nasdaq Stock Market, Inc., The
N.A.S.I.P
Nat City Investments
Nat Institute of Investments
National Association of Real Estate Trust
National Center for Cont. Education
National City Cleveland/Trust
National Institute of Investment Research
National Mortgage News
National Order Educators
National Planning Corporation
Nationwide Financial
Navellier-MPT Review
Navigant Consulting, Inc.
NBC Levesque International Ltd.
NCM Capital Management Group, Inc.
Nebrask Investment Council
Nelson Industries Profit Sharing
Neo Technologies
Neovest, Inc.
Netteks Technology Consultants
Network Appliance
Network Access Solutions
Neovision Hypersystem
Nevada Institutional Investors
New Economy Watch
New Edge Networks
New Pittsburgh Courier
New York University Stern School of Business
New York Stock Exchange, Inc.
New York Times, The
NewsEdge Corporation
Newsware, Inc.
New Vernon Associates Inc
Nicholas-Applegate Capital Management
Nielsen Media Research
Niemeyer, Korwin-Krystyna

Nikkei Data
Nilson Report, The
Nirvana Systems Inc.
Noah Financial, LLC
North River Ventures
North Shore Printers
Northern Trust Quantitative Advisors
Northfield Information Services Inc.
Novalink Limited
NYU Stern School of Business

Oak Associates, Inc.
Oasis ComputerSolutions
Oasys
Object Design
Oceanview Financial Research, Inc.
Omgeo LLC
One Source Information Services, Inc.
Onsite Access, Inc.
Open Systems Technologies
Optima Investment Research, The
Options Price Reporting Authority
Oracle Corporation
OrbiMed Advisors, LLC
Orderpoint TIS
Orford Capital Management
Orion Research Partners
OTA-Off The Record Research
OTC, Inc.
Outstanding Investor Digest

P. C. Quote, Inc.
Pacific Bell
Pacific Growth Equities
Pacific Pension Institute
Pacific Select Distributors
Paladin Investment Associates
Pan Pacific Software LLC
Patrick Hayden (Consultant)
Patriot-News Co., The
Patterson Capital Corporation
Paul Kagan Associates
Payden & Rygel
PCI (Xylenes & Polyesters) LTD.
PC Magazine
Peachtree Software
Penfold Limited
Pensions 2000
Pennisula H/V Beach EN, The
Penobscot Group Inc., The

Pensions 2000
Pension Benefit Information
Pensions and Investments
Perception International
Performance Services Group
Performance Technologies, Inc.
Peter Cole and Company
Peter Mikolaj & Associates
Petroleum Intelligence Weekly
PharmaBooks Ltd
Philadelphia Newspapers, Inc.
Philadelphia Tribune (The)
Phileo Allied Securities
Philip S.P. Randolph, Inc.
Phillips Global Media
Phillips Office Products, Inc.
PictureTel Japan Co. Ltd
Pillette Investment Management, Inc.
Pittsburgh Post Gazette
Pira Energy Group
Pittsburgh Post Gazette
Plan Sponsor Network, Inc.
Platformedia LLC
Platt's Oilgram Price Report
Platt's Newsletter/Newswire
Plexus Group
PNC Bank
Polyconomics, Inc.
Pomeroy Computer Resources, Inc.
Portfolio Management Technology
Portfolio Solutions
PREA
Precision Timing
Precursor Group
Premier Solutions
Preservation Research
PricewaterhouseCoopers
Primark Canada, Inc.
Primark Decision Economics, Inc.
Prime, Buchholz & Associates, Inc.
Princeton Economic Institute, Inc.
Princeton Financial Systems
Princeton Retail Analysis
Private Equity Analyst, The
Proequities Inc
Professional Alternative Inc.
Professional Expert Trading Systems
Professional Training Services, Inc.
Protel Communications Ltd.
Provident Investment Counsel
Proxy Monitor, Inc.
Proxy Voter Services
PRS Group (The)
Publishers Service Exchange
Puget Sound Economic Forecaster
Putnam Advisory Company, Inc.
Putnam Investments Inc.
Pzena Investment Management

Q-Tech Communications
QED Information Systems
Quantec Investment Technology
Quantitative Analysis Service, Inc.
Queens City Financial Consultants
Quest
Quick, Moneyline, Telerate Corp.

R & B Financial Solutions
RCG Information Technology Inc.
R.H. Wrightson & Associates Inc
R.W. Mansfield Co., Inc.
Ranking Service, The
Radio Business Report
Rampart Investment Management
Real Estate Alert
Real Estate Transformation Group
Reference, Inc. The
Regulatory Research Associates
Reininga & Company
Reinganum Consulting
Reliable Corp (The)
Renaissance Capital
Renaissance Worldwide IT Consultants
Republic Security Bank
Research Network (The)
Research Works
Research Vision Limited
Resource Advisory, Inc.
Resource Center (The)
Reuters America, Inc.
Reuters India Limited
Reuters LTD (Austria)
Reuters Singapore Pte Ltd.
Richard L. Hanley Associates
Richards & Tierney Inc.
Ried Thunberg & Co Inc.
Righteous Intl. Subscription Services
Risk Conferences and Training Courses
Riskmetrics Group LLC
Rittenhouse Financial Services

Riverplace Consulting Services
Robert F. Fargo & Co., Investment Res.
Rockefeller Treasury Services
Rogers, Casey and Associates
Roxbury Capital
Roxin and Company
Royal Oaks Consultants Group
Royal Institute of International Affairs
Ruarte's Report
Rudd and Wisdom, Inc.
Ryan Labs, Inc.

Salomon Analytics Inc.
Santa Fe Institute
Sayers Consulting Services
Schroeder Advisory Services, Inc.
Schulte Roth & Zabel LLP
Schwab Performance Technologies
Schwab Washington Research Group
Scientific Investing
Seagate Software
Seamans Capital Management
SEC Insight
Sector, Inc.
Sectorbase.com, Inc.
Securities Data Publishing
Securities Industry Automation Corp.
Securities Operations Forum
Securities Research Company
Securities Software & Consulting, Inc.
Segal Company (The)
Segall Bryant & Hamill
Seidel Associates Incorporated
Select Equity Group, Inc.
Semantic Architects
Seneca Capital Management
Sentinel Pension Institute
Seward & Kissell LLP
Shands Jacksonville Medical Center
Shartsis, Friese & Ginsburg, LLP
Short Capital LTD
Siemens Business Communication
Sierra Investment Partners
Sigma Systems, Inc.
Silverback Networks, Inc.
Simplified Computer Services
Simon-Hunt Strategic Services
Sims Moss Kline & Davis LLP
Simsbury Electronics, Inc.
SIT Investment Associates, Inc.
Sitelis Design Studio
Skytel Pagers
Smith's Research & Rating Review
Smithers & Co. Ltd.
Software Spectrum
Solsource Computers, Inc.
Soliton Associates, Inc.
South African Inst. Of Race Relations
Southland Sound Corporation
Sovran Capital Management Corporation
Soyata Computers of Rochester
Spartan Institutional Research, Inc.
Spencer F. England & Co., Inc.
Spencer Fane Britt & Brown LLP
Sprucegrove Investment Management Ltd.
SSI Technologies PTE., LTD.
St. Louis Business Journal
Stafford Publications
Stalla Seminars
Standard Club (The)
Standard Valuations, Inc.
Starmine
Startspot Mediaworks
State Street Bank and Trust
State Street Global Advisors
Statsci
Statsoft
Stax Inc
Stellcom Technologies
Stern Stewart & Company
Stevens Publishing Corp.
Stock Data Corporation
Stock Management, Inc.
Stock Market Geometry
StockVal, Inc.
Stone & McCarthy Research Associates
Strain Consultants Inc.
Stratecon Corporation
Strategic Economic Decisions, Inc.
Strategic Insight
Strategic Investment Solutions
Strategic Morning Line
Street Software Technology, Inc.
Stremkal Inc.
Stroh Corporation
Sturza's Institutional Research
Sugarman and Susskind, P.A.

Sun America Capital Services, Inc.
Sun Microsystems
Superstock Investors
Syscom, Inc.
Symmetria Software LLC
Syntegra
Synergistics Technology Inc.

13D Research
Taj Technologies, Inc.
Taylor Consulting Inc.
Team Systems
Tech Hackers, Inc.
Technology Investing
Technology Solutions International
Telecommunications Reports
Telemet America Inc
Teleport Bermuda Limited
Telerate Systems, Inc.
Telesphere Corporation
Tempus International Ltd.
THL Managers V LLC
Thomson Asia PTE LTD.
Thomson Corporation HK
Thomson Financial Media
Thomson Financial Muni Group
Thomson Financial – Portfolio Solutions
Thomson Financial – Solutions
Thomson Wealth Management
Tiboco Financial Technology
Thomson Asia PTE LTD.
Tillinghast-Towers Perrin
Time Inc. Asia
Time Magazine
TIS Group, Inc.
Tokyo Stock Exchange Computer System
Topline Investment Graphics
Toronto Stock Exchange, The
Torch Capital Corporation
Toyo Keizai, Inc.
Townsend Group, The
Track Data Corp
Trade Management Systems, Inc.
Trade Web
Trade Winds
Trade Wins Publishing
Trading & Investment Programs & Systems
Tradenet Corporation
Tradition Financial Services Inc.
Trans-Lux Corporation
Transmarco Data Systems Pte Ltd.
Trans-National Research Corporation
TRD Consulting, Inc.
Trepp Management Group
Tri-State Envelope Corporation
Trias Capital Management
Trim Tabs Financial Services, Inc
TRS Staffing Solutions,Inc.
True Solutions,Inc.
Tuff Management Co.
Turnaround Letter (The)
T.W. Cooney & Associates
Twin Capital Management, Inc.

U. S. Offshore Funds Directory
U.S. Communication, Inc.
U.S. Micro
UCLA – Anderson Forecast
Unisys Corporation
United Data
United System Solutions
University of Miami Diagnostic Clinic
UNIWEB-NET
US Connect
US West Communications
Utility Pension Fund Study Group
UUNET Technologies, Inc.
Uvest Investment Services

Vanstar
Veneroso Associates
Venture Financial Systems Group, Ltd.
Venture One
Vertex Computer Cables & Products
Vestek Systems
Vickers Stock Research Corp.
W.H. Brown & Co., Inc.

Walker's Manual, LLC
Wall Street Calendar Corporation
Wall Street Journal, The
Wall Street Source, LLC
Wall Street Strategies
Warwick Business School
Washington Research Group
Wedge Capital Management, Inc.
WEFA Group, The

Wellington Management Company
Wells Fargo, Institutional Trust Division
Wharton Real Estate Review
Wharton School Executive Education
WHO Investment Consulting Company
William R. Hough & Co.
Williams Inference Service, The
Williams & Jensen
William Smith Special Opportunities Research
Williamsburg Investment Co.
Windhover Information, Inc.
Winter, Wyman & Company
Wipro Limited
WM Company, The
WM Smith Special Opportunity Research
Woodmentum Technical Research
World Steel Dynamics, Inc.
World Bank, The
World View, Inc.
Wyatt Investment Consulting, Inc.

Yankee Prognostics, Inc.
Yanni-Bilkey Investment Consulting
Yelton Fiscal, Inc.
Yon Drake & Associates

Zacks Investment Research, Inc.
Zephyr Associates, Inc.
ZPR International, Inc.,

Appendix A

Views of an "Informed" Trader

Harold S. Bradley
Senior Vice President
American Century Investment Management
Kansas City, Missouri

The traditional and customary practices of order execution, including the use of soft dollars, are too often in conflict with achieving best execution for investors. Thus, these practices have come under scrutiny by the U.S. SEC and industry standard setters (such as AIMR), and firms have come under pressure to increase trade transparency and improve record keeping and accountability. Among the steps firms should take in this new environment is to demonstrate dedication to reducing trading costs, and among the best tools for that purpose (despite what many in the industry believe) is the electronic communication network.

As a former trader and portfolio manager at American Century Investment Management (ACIM), I have observed firsthand the difficulties involved in trading and the achievement of best execution. In particular, I have noticed how much of the investment management business uses the trading desk as a bill-paying function to support the business enterprise rather than as a mechanism for carrying out the fiduciary obligations owed to the client to provide best execution and to maximize the value of investment decisions. In this presentation, I will discuss the problems that stem from the myriad cross-subsidies that have been built into the commission stream and discuss how the current research payment systems may be subject to regulatory scrutiny and reform.

What Is Best Execution?

A definition of best execution appears just about everywhere: due diligence manuals, marketing presentations, consultant questionnaires, and requests for proposals. No legal definition exists, however, or at least traditionally, there has not been one. Thus, the search for best execution has proven elusive, despite the many assurances otherwise. "We know it when we see it, but it is really hard to measure," is an oft-quoted expression on trading desks when alluding to the concept of best execution. Traders are not paid to make decisions that really work to achieve best execution and have disincentives to doing so: They have soft dollar chits to pay and shares waiting to trade for impatient, demanding, and often unrealistic portfolio managers. Traders operate under what I call "maximum risk aversion for maximum pay on the desk." As a portfolio manager, when I made a bad decision, I blamed the trading desk. Trading is a function in which it is difficult to claim "value added" and easy to look bad in a handful of trades. As a result, it is no surprise that traders give the ambivalent answers they do when asked about best execution.

New Definition. In 2000, before leaving the U.S. SEC, former commissioner Arthur Levitt started the process of articulating new standards for best execution. At the same time, both the Investment Company Institute (ICI) and AIMR were asked to convene best practices groups to help define best execution. At the December 2000 ICI Securities Law Development Conference, Gene Gohlke, associate director of the SEC Office of Compliance Inspections and Examinations, offered this definition of best execution:

> In placing a trade, the trading desk will seek to find a broker/dealer or alternative trading system that will execute a trade in a way that the trader believes will realize the maximum value of the investment decision.

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Given the conventional wisdom surrounding best execution, this definition presents a challenge to the industry.

The "investment decision" referred to in Gohlke's definition pertains to the particular trade being executed—not to Goldman Sachs' research yesterday, First Boston's research last week, or a consultant who directs a lot of business to the firm. In terms of words, the change is minor, but in terms of policy, the change is rather substantial. And the addition of "alternative trading systems" in the definition is a big change. The use of electronic communication networks (ECNs) and nontraditional trading systems has exploded in the market in the past 10 years. Yet, I am told that on the buy side, institutional money managers still directly use these systems less than 7–8 percent of the time.

In his presentation at the ICI Conference, Gohlke identified possible areas in which SEC auditors will spend more time. Note that he was not talking to investment professionals but, rather, to the lawyers who advise the outside directors who, in turn, advise funds and money managers. Investment managers have fiduciary obligations to boards as well as to investors in the areas of compliance systems, compliance evaluation procedures, and record keeping. Accordingly, the SEC is saying that the hiring of a consultant to measure execution quality is not sufficient proof that a manager is in compliance with getting best execution; the adequacy of order-handling systems, trade-error experience, and timeliness of execution reports will be reviewed; and the allotment of initial public offering (IPO) shares against requested allocations will be assessed.

Basically, the SEC appears to have serious concerns about how Section 28(e) of the Securities Exchange Act of 1934, which provides a "safe harbor" for firms to pay up for research, has been used and interpreted. In addition, the use of ECNs—as venues that provide greater liquidity, price improvement, and lower commission rates—will be evaluated. Many people on the buy side are not using ECNs, and this new mandate from the SEC means that the regulators want to know why.

AIMR Trade Management Guidelines. AIMR's proposed Trade Management Guidelines on best execution were announced in November 2001.[1] The AIMR recommendations are consistent with the direction of the SEC. The guidelines recommend the establishment of trade management oversight committees that will be responsible for developing a trade management policy and a process to manage the efficacy of trades. Are you getting what you are paying for? Are you evaluating the service you received? And are you evaluating the providers of that service?

Specifically, the implications of these guidelines are as follows:

- Substantial infrastructure spending will occur to build record-keeping and reporting systems to track and audit trading information appropriately because so many firms still operate with inadequate order management systems.
- The negotiation of acceptable commission ranges and documentation of the variance between negotiated and actual commission rates will become necessary. Commission rates that held at 5–6 cents a share for more than a decade should and will be negotiated down to a level closer to the 1.00–1.25 cents a share rate paid on ECNs for execution-only services.
- Trade management oversight committees will be established, and the internal documents prepared for these committees will be auditable by the SEC. The SEC has already been asking for these materials.
- Real and potential conflicts of interest must be documented.
- The choice of a particular trading system must be supported, and the review and evaluation of trades, broker selection, and execution performance can be expected.

What Are Soft Dollars Really Buying?

In Gohlke's definition of best execution, traders are charged with maximizing the value of the trade decision. But Robert Schwartz, the Marvin M. Speiser Professor of Finance at Baruch College, City University of New York, and Benn Steil, at the Council of Foreign Investors, have studied how little control traders actually have over the execution decision. They sent questionnaires to the chief investment officers of major investment companies that asked, "Who at your firm controls institutional commission payments?" They found that 62 percent of all trades are not controlled by traders.[2] (This finding is consistent with my experience as a trader and portfolio manager.) The report also addresses how often commissions are used to pay for things other than best execution. And Steil, aggregating the information from a variety of reports on commission bundling, has stated that nearly two-thirds of soft dollar agree-

[1] The proposed guidelines are available at www.aimr.org/pdf/standards/proposed_tmg.pdf, and the final guidelines are expected to be issued in November 2002.

[2] Robert Schwartz and Benn Steil, "Controlling Institutional Trading Costs," *Journal of Portfolio Management* (Spring 2002):39–49.

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ments are unwritten and more than one-third of brokers are a party to illegal soft dollar arrangements.[3]

Clearly, soft dollar agreements play an important role in the execution decision and are often in direct conflict with an investment firm's fiduciary duty to the client. What are soft dollars really buying? How extensively is soft dollar business affecting the trading decision and ultimately usurping the goal of best execution?

Research. Investment managers pay up for execution and have a safe harbor to do so to some extent under Section 28(e), because in exchange for paying up, they receive company proprietary research services, including access to analysts and road shows with corporate executives. But now that these executives are subject to Regulation Fair Disclosure (FD), why are managers still willing to pay up?

The willingness to pay up is especially thought-provoking because most investment management firms choose to "buy" their research from brand-name companies (paying up relatively more), even when firm or brand name is obviously not a proxy for quality. Based on the following observations, this attraction to brand appears to be quite misplaced: Only 41 percent of analysts at the 10 largest brokers (what I consider the brand-name brokers) rank as StarMine four- or five-star analysts, compared with 35 percent of analysts at all firms having 10 or more analysts.[4] Rankings are based on the earliest directional correctness and accuracy of the analysts' EPS estimates for the trailing four quarters and two years as well as on the accuracy of buy, sell, and hold recommendations. The top five firms with the largest percentage of four- and five-star analysts are regional or niche research firms without significant investment banking activities, namely, Buckingham Research Group, Gerard Klauer Mattison, Pacific Growth Equities, U.S. Bancorp, and WR Hambrecht + Company. At the 10 largest brokers, 25 percent of the analysts ranked poorly, as one- or two-star performers. Obviously, the rationale that brand-name research is a worthy use of the client's commission dollar is suspect at best. Yet, the industry persists in supporting the practice of "buying" research with soft dollars, which is a major factor in holding negotiated commission rates at the 6 cent level.

■ *A safe harbor?* In his speech to the Securities Industry Association in November 2000, Levitt asked whether portfolio managers were bringing to bear the pressure they should on brokerage commission rates and why the emergence of electronic markets had not driven full-service commissions lower. If a trade on an ECN costs a penny or less a share, why do most people on the buy side still pay 5–6 cents a share? Do portfolio managers and independent directors think 6 cents is safe, that it falls within the safe harbor exception of Section 28(e)?

Levitt said that 6 cents is not a safe rate and that those who think it is should reexamine the part of their business that is predicated on 6 cents being safe. The status quo of the industry's trading and execution practices is being seriously challenged by the SEC. And **Figure 1** shows that, although the median commission rate has been steadily decreasing since 1989 because of technological advances and commission unbundling, immediately following Levitt's speech in 2000, the median rate dropped below 5 cents a share. Apparently, the market heard and understood the message.

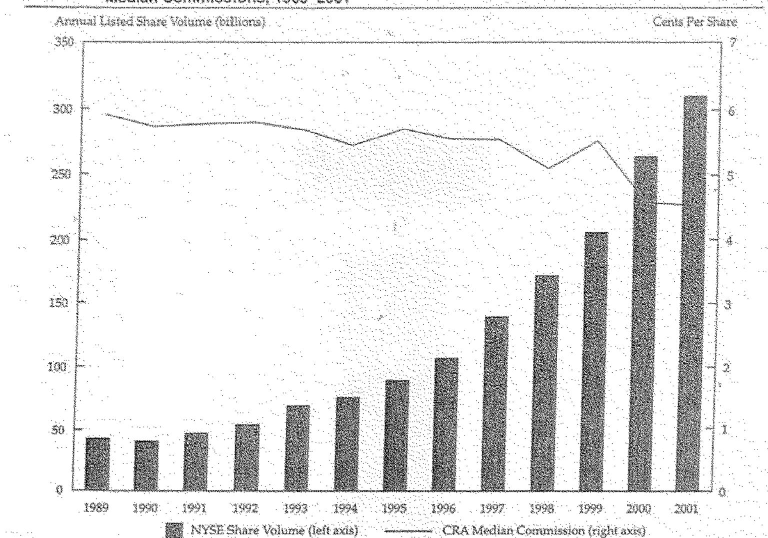
■ *The real cost of research.* Understandably, investors must pay a cost for block trading, capital facilitation, value-added research, and IPOs, but what is that cost (i.e., the real cost of trading)? **Figure 2** compares average cost-per-share rates at ACIM with the industry median. The solid dark line depicts the rates our agency brokers have been willing to negotiate. The rate has not dropped significantly since 1989, even though we have tried, with minimal success, to move it lower. (Of course, with regulators and professional organizations such as AIMR and ICI moving the issues of best execution and soft dollar business to the forefront, the tenor and tone of the market changed markedly in 2001.)

The dashed line in Figure 2 shows ACIM's average cost for using ECNs, where we do 35–40 percent of our business. The difference in the rate charged by our agency brokers and the rate charged by the ECNs can be thought of as a premium paid for research. In 2001, this premium was at an all-time high. When the value of research should be worth far less than ever before, given Regulation FD and the information overload via the Internet, the cost of soft dollar research is at a record high mainly because technology has lowered the *real* cost of trading while the "old rules" of trading and execution have kept the actual cost of trading artificially high.

I used to be convinced that the more business we did on ECNs, the more our costs would rise (and the less the marginal benefit would be) because of a structural reversion to the mean. **Table 1** illustrates, however, that the mean for all-in trading costs is down, not up. As our business on these nontraditional systems increases, our overall efficacy, as measured against other brokers doing similar business in

[3] Benn Steil, "Can Best Execution Be Achieved in the Current Market Structure?" Presentation given at the AIMR conference "Improving Portfolio Performance through Best Execution," November 30–December 1, 2000, Chicago.
[4] StarMine is an ACIM portfolio company.

Figure 1. NYSE-Listed Share Trading Volume and Capital Research Associates' (CRA's) Industry Median Commissions, 1989–2001



Note: Commission chart inclusive of ECN agency fees.

the same time frame, has widened. ECNs are far more effective than the traditional exchanges. They remove structural, intermediated costs.

The nontraditional players, highlighted in bold in Table 1, are important; in particular, B-Trade, Archipelago, and Instinet have helped lower our costs of trading. Broker 3, one of the most respected Nasdaq market-making firms in the business, produced costs equal to 2.03 percent of principal, round-trip, on Nasdaq trades, whereas Archipelago and Instinet both produced a negative cost. According to Capital Research Associates' methodology, "negative cost" means that the day after our order is finished, the price of the stock we sold is still falling. In other words, we have not telegraphed our intentions to the rest of the market in moving big orders, and we have succeeded in executing at a relatively fair price.

Use of electronic trading for listed stocks has only recently begun to pick up steam; Archipelago linked into the Nasdaq system to display orders in the public market early in 2001. Traders can now put their order indications into the public quote system and split the spreads charged by the specialists. The ability to lower costs this way is compelling.

Market Stability. For decades, brokers have justified all types of structural cross-subsidies by claiming that when markets are under stress, the broker will help stabilize the market. The popular theory was that the ability to get best execution depends on a broker's willingness to lay capital on the line during times of market-distress, when that capital infusion is really needed.

In their article, Schwartz and Steil conclude, instead, that the buy-side institutions' call on street capital for immediacy of execution is an insurance or option to protect the investment manager's identity and order size from being captured by intermediaries and transmitted to competitors—to avoid being front-run. To support their contention, Schwartz and Steil point out that, based on the responses to their

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Figure 2. Historical Commission Trends, 1989–2001

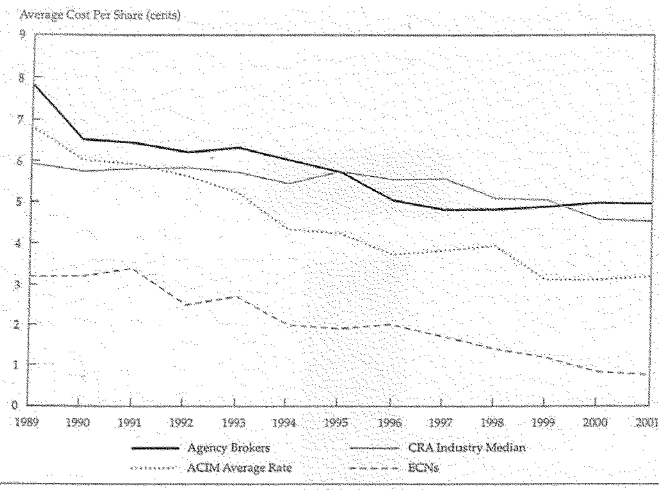

Table 1. Capital Research Associates' Study of ACIM All-In Trading Costs

Broker	Dollars Traded	Average Market Cap (billions)	Average Volatility	Cost as Percentage of Principal	
				OTC	Listed
ACIM funds average	$47,607,820,875	$56.76	51%	0.49 bps	0.32 bps
Broker 1	4,263,056,375	48.67	45	0.66	0.28
Broker 2	2,637,630,000	47.28	45	0.93	0.23
Broker 3	1,672,943,750	42.69	56	2.03	−0.40
Broker 4[a]	1,738,325,000	35.23	51	−1.00	0.24
Instinet	2,219,195,000	61.35	61	−0.23	−2.72
Crossing Network	923,983,750	45.17	53	0.61	−0.25
B-Trade	3,697,211,250	56.24	63	0.84	−0.28
Archipelago	5,855,745,250	65.83	64	−0.06	−0.46
Traditional brokers[b]	10,311,955,125	43.47	49	0.66	0.09
Electronic brokers	12,696,135,250	57.15	60	0.29	−0.93

Note: Data reflect non-dollar-weighted mean of 10 six-month periods, June 30, 1997, through June 30, 2001 (post-order-handling rules).

[a]Negative OTC costs are a function of aftermarket IPO performance.
[b]The "traditional brokers" category reflects four large brokers only.

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survey, portfolio managers only rarely create orders based on seeing the other side through a telephone call, trading activity, or order flow in the market. Investment managers appear to be attributing their willingness to pay up for liquidity to a reason that is not borne out in practice.

Order Life Cycle

Understanding how orders are executed and how the trading system is changing can shed light on the challenges of achieving best execution because of competing interests in the trading process. The life cycle of an order at the NYSE follows a convoluted route littered with at least seven intermediaries: An order travels from a portfolio manager to the trader; to a broker sales trader; to a "block," "position," or "upstairs" trader; to a floor broker; and finally, to the specialist post. Here is how it works. A portfolio manager decides to buy a stock and calls his institutional trader at the trading desk. That trader then tries to figure out which broker she might have heard from in the last two days that might have an order in that stock or, as likely, identifies a broker to whom the manager owes a consultant bill or who holds a soft dollar chit. She then gives the trade to the trader at that brokerage firm. The broker sales trader is the most frequent and trusted point of contact for the institutional sales trader.

But then there is the broker "upstairs" trader, whose job is to trade the firm's block capital. The reason brokers staff a sales trader position is ostensibly to protect the investor from the upstairs trader. For example, if the investor gives a 500,000-share order to the sales trader in Chicago, a trusted sales trader will not immediately disclose this information to the upstairs trader in New York. If the upstairs trader communicates this information throughout the system and is then asked to bid someone else's stock, that information alone might trigger "go along" activity and have an unfavorable impact on the price of the first trader's order. Investors need protection from the upstairs trader, but that upstairs trader is also the broker's representative for the investor's interest with the NYSE floor broker. The floor broker may be representing not only the firm representing that investor but also other firms and, therefore, other investors. The floor broker then goes to the specialist, who posts the order to the tape as part of the National Best Bid and Offer (NBBO) system, as seen on Bloomberg. The whole process is repeated on the other side of the trade.

Now consider order half-life. Orders travel from investor to specialist, with successively smaller order amounts passing from trader to trader within this sort of "bucket brigade." Everybody buys and sells exactly the same way. After an investor gives the institutional trader 500,000 shares to trade, that institutional trader gives the sales trader 250,000 shares to trade. The sales trader gives the upstairs trader 125,000 shares to trade, and the upstairs trader, through the floor broker, tells the specialist to post 25,000 shares. With such a system, no wonder traders believe that trading is a win–lose function.

In a market driven by eighths (before decimalization), commissions and trading spreads were plentiful and the mix of traditional roles in the execution process was sufficient assurance that everyone on the sell side would do well. In a market now driven by decimals, the life cycle of an order has not changed but the economics of the business certainly has. In the retail universe, a theory exists that payment for order flow and internalization of orders has been a large part of the profits of the business. This precedent is collapsing because both ECNs and decimalization have so markedly changed the economics of the execution process.

The Specialist. Because of the completely counterintuitive auction rules that govern trading on the NYSE, getting the best price in the market is often difficult. Let me explain what I mean with the following example. Say I go to a wine auction to buy a special case of wine. I want this wine badly because it is rated as one of the top wines of the new vintages; in 10 years, it will be worth a bundle, plus I will have good wine in the cellar. The bidding starts and quickly rises to $3,000 a bottle. I know I should not pay that much, but the auctioneer calls the bid and says I just purchased the wine. The case is opened, and I am handed four bottles—and then four bottles go to a person who was sitting three feet away from me who never opened her mouth, and another four bottles go to someone on the telephone. Before the bidding started and unknown to me, these two people said that they wanted to participate in the trade and buy at the highest price that cleared the supply.

Such are the rules of trading at the NYSE. The rules allow free options to third parties, so despite the theory published in the academic literature on auction markets, serious obstacles exist to discovering an appropriate clearing price. As long as a third party is allowed to forgo the risk of price discovery, that third party gets a free option on whatever is being traded. I find that situation fundamentally wrong. In my earlier example, the wine seller did not get the right price because I, as an interested buyer, was not allowed to bid for all the bottles I wanted and the other bidders were essentially removed from the bidding process altogether.

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Little information is available on the profitability of specialists. A major NYSE specialist firm, LaBranche & Company, did recently go public, however, which provided some clues. The initial offering prospectus showed that LaBranche consistently earned more than 75 percent of its profits from dealer trader activity, had been profitable every quarter for 22 years, and averaged consistent returns on capital and equity of more than 70 percent. If LaBranche's numbers are typical of the economics of NYSE specialists, are investors benefiting from the intervention of the specialist, or do specialists simply impose another layer of expense?

Clean Cross Rule. The clean cross rule (Rule 72[b]) at the NYSE also grants a free option for liquidity takers and proprietary interests. A clean cross is a trade involving a matched pair of buy and sell orders of 25,000 shares or more that cannot be broken up (that is, disclosed floor interest is not included in the trade). Rule 72(b) currently gives priority to clean crosses at or within the prevailing quotation, and crosses are not allowed if any part of the cross is an order for the account of a member or member firm. An amendment to Rule 72(b) filed by the NYSE provides for clean crosses even if all or part of the order is for a member or member firm. Say you are a buyer bidding for 25,000 shares at $20 and the order is on the book as a limit order displayed for the whole world to see on Bloomberg. A broker has a customer who wants to sell 100,000 shares at $20 and another customer (or the broker himself) who wants to buy 100,000 at $20. They trade with each other, and your order remains unexecuted. Such a situation is worse than the situation with the specialist I just described because under the amendment, a broker can trade proprietarily on one side of a block trade and ignore preexisting orders on the trading floor.

The rules of trading are designed for the intermediaries and grant absolute free options to limit order traders in the market. Transparent limit orders provide the basis for price discovery in listed equities markets. I believe limit orders are an endangered species.

Institutional Xpress. The NYSE has finally paid attention to the ICI, which has been saying for a long time that limit orders are being subjected to free options. Accordingly, the NYSE established Institutional Xpress, which is designed to allow the institutional investor to take an offering or hit a displayed limit order through the NYSE DOT (designated order turnaround) system without an attempt to gain price improvement. Ironically, the rules governing Institutional Xpress provide an opportunity for, instead, price improvement of a market order. This is but another example of rules beneficial to brokers and inimical to the interests of buy-side traders.

Why *Not* ECNs?

ECNs improve the traditional execution mechanism and eliminate the requirement of dealing with the specialist. An ECN is a limit order book, and limit orders have primacy. The most important aspects of primacy are price priority, time priority, anonymity, and an order cancellation privilege—absolute control over entry into and exit from the market. The ability to cancel orders at will establishes a potential time value on options; they are no longer free. Nicholas Economides and Schwartz found that investors appreciate the motives for trading on ECNs but that the soft dollar arrangements that traders must satisfy may stymie ECN use.[5]

Nevertheless, despite the electronic trading systems' proven advantages, the buy side still has not welcomed ECNs with open arms. Ian Domowitz and Steil concluded:

> An examination of total trading costs, inclusive of commissions, reveals electronic trading to be superior to traditional brokerage by any measure of trade difficulty for buy trades and to be comparable for sells.[6]

Traders give several reasons for not trading on ECNs. Traders claim that large orders cannot be executed efficiently on ECNs and that executing through ECNs conflicts with the immediacy required to execute before an anticipated market move. Traders need to recognize that, in fact, ECNs not only offer the anonymity they seek but can also effectively execute large orders through rapid-fire, small, block-equivalent trades—as do brokers and market makers today.

Anonymity. Above all, both buy-side *and* sell-side traders seek order anonymity in the market. Yet, the identity of the firm, the size of the firm, and its trading practices are all known by the intermediary chosen to execute an order for a buy-side client. That intermediary has a relationship with at least 200 other high-commission-paying firms. Certainly, a relationship with some degree of trust exists between the trader and the sales trader, but that trust can break down rather easily. Because of the very nature of the

[5]Nicholas Economides and Robert A. Schwartz, "Equity Trading Practices and Market Structure: Assessing Asset Managers' Demand for Immediacy," *Financial Markets, Institutions & Instruments* (November 1995):1–45.

[6]Ian Domowitz and Benn Steil, "Automation, Trading Costs, and the Structure of the Securities Trading Industry," *Brookings-Wharton: Papers on Financial Services*, edited by Robert E. Litan and Anthony M. Santomero (Washington, DC: The Brookings Institution, 1999):33–81.

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system, then, believing that a firm is working just for you or not leaking information about your order into the system is naive. ECNs, however, are the very definition of anonymity in trading.

Size. Traders have been heard to say, "Look at these screens. The orders are all for 1,000 shares, and on Nasdaq, they are offering 100 shares; there is no liquidity." This liquidity argument is largely moot; large, hidden limit orders, which are basically reserve quantities, exist on ECNs. The Nasdaq has just petitioned for a rule change that would allow market makers to show only 100 shares of an order to the market while at the same time placing as much as tens of thousands of shares in a nontransparent order queue. A benefit of this capability is that to trade 1,000 shares, you can execute 10 trades of 100 shares electronically and virtually simultaneously without advertising to adversaries what you are doing.

Buy-side traders prefer to trade large blocks of stock because blocks are easier to account for and to book. The typical trader's viewpoint is that block trades cannot be executed on ECNs. But we find that when we use an ECN for listed trades and an order is published and highly visible, we tend to attract the other side of an order more easily. That advantage has interesting implications, especially considering the recent merger between Archipelago and REDIBook and the SEC's approval of Archipelago becoming a fully electronic exchange. With the emergence of a fully electronic exchange, the buy side will apparently be able to drive the best price in the market while avoiding unnecessary intermediation.

A block trade that uses a broker's capital is not a charitable gift. Brokers traditionally "rent" capital when trading a block because natural counterparties are said to occur only about 20 percent of the time. Brokers regularly make capital for block facilitation available only to payers of the largest commissions—which is functionally identical to offering a commission discount. Then, if they lose money on the trades, they earn full "rents" from smaller full-commission players, so they are making up the difference with commissions from the smaller firms that do not have that same kind of leverage with the broker. This "loss ratio" is a major component of the cross-subsidies that underpin the soft dollar business. Ultimately, the little guy loses.

Historically, brokers served as "small order aggregators" working off negotiated block transactions in small increments over the phone, SelectNet, or ECNs. ECNs, however, eliminate the risk premium that institutions pay to trade; technology replaces capital in the aggregation process.

Our traders work aggressively to get the best price for block size on ECNs. At ACIM, we use FIX technology, the financial information exchange protocol, to send orders to ECNs, and we have been successful in trading extremely large orders on ECNs; we regularly execute orders of more than a million shares. Surprisingly, the average trade size for a Nasdaq stock on an ECN is fewer than 1,000 shares. We use DOT and Archipelago to access the liquidity on the NYSE, and we are increasingly successful at trading large orders in NYSE-listed securities on ECNs.

A good example of our success in trading blocks on ECNs is what we were able to accomplish during the period from June 1 to August 31, 2001, the summer doldrums, when the entire equity market's volume is at its lowest level. We averaged on a daily basis more than 13 orders of more than 50,000 shares; 6 orders between 50,000 and 100,000 shares; 4 orders between 101,000 and 250,000 shares; and almost 2 orders between 251,000 and 500,000 shares. And these trade sizes are fairly conservative in terms of what can be executed on ECNs. For example, during the same period, we used ECNs to trade 12.1 million shares of AOL with an average order size of 202,000 shares and a total principal value of $526 million. We also traded 12.1 million shares of Pfizer ($494 million of principal and average order size of 181,000 shares).

We chose to make these trades on ECNs because we wanted anonymity. When the market sees you trading in a name, the other buyers immediately look to see how big you are in the name and make inferences about why you are selling or buying. That is how the Street anticipates price action.

Immediacy. Another buy-side trader objection to using ECNs is the need to implement a trade "right now" in one block at a single price. Part of the trader's demand for immediacy is the culture of blame transfer—that is, portfolio managers blaming traders for the portfolio managers' own mistakes. When the buy-side trader hands an order to a broker, the trader has someone to yell at on behalf of an impatient portfolio manager.

Schwartz and Steil surveyed portfolio managers and chief investment officers about how much weight they give in stock purchase decisions to an estimate of share price in one day, one week, one quarter, one year, and two years or more. Most managers profess that they do not care what the share price will be one day or even one quarter out but do care about the price at one to two years out. That finding has profound implications. Why would portfolio managers, who may take days or weeks to make a purchase or sell decision, expect a trade to be done "right now" unless their ego is heavily invested in micromanaging the trader? Schwartz and Steil also asked how soon the managers expected a price correction to occur

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when buying or selling a stock that was believed to be mispriced. Most answered one month to one year or more than one year, not less than an hour or one week to one month. So, again, managers' timing expectations do not appear to align with their demands. Immediacy is simply not the impetus for trading that many managers claim.

Changes Affecting ECNs

In 1975, the Exchange Act called for a linked national market in which prices in one market would be respected in other markets. More than 20 years passed before the SEC took another major step toward encouraging market linkage with the enactment of the order-handling rules in 1997. These rules were an attempt to tie together markets fragmented by Instinet and other ECNs. It required ECNs to include orders in the public display of the NBBO. Although the Nasdaq intermarket gives ECNs a path to the listed market and exchange-traded funds, barriers to unification of the markets exist, such as the access fee the ECNs are charged. Archipelago chose to voluntarily comply with the order-handling rules but is the only ECN to have done so. The SEC has suggested that the application of the order-handling rules and Regulation ATS (alternative trading systems) to listed stocks is unfinished business. ECNs, however, represent an estimated 40 percent of Nasdaq volume, and ECN quotes drive the inside market.

The intermarket trading system (ITS)/Computer Assisted Execution System (CAES) link to the NBBO offered by Nasdaq to its members, who include Archipelago, is rapidly changing the marketplace. For the 62 days ending March 31, 2001, before Archipelago linked to the market through ITS/CAES, we traded only 35 orders for NYSE-listed stocks, compared with 121 listed orders in the 65 days after the linkage on August 31, 2001. Pre-ITS/CAES, these orders were excluded from market quotes, but post-ITS/CAES, the orders were transparent as limit orders to all market participants. We can now advertise our intention to trade.

Nevertheless, some traders are expressing frustrations similar to those expressed about Nasdaq trades before the instigation of the order-handling rules. The complaint is about "trade-throughs" and "backing away" (the latter occurs when one linked market trades at an inferior price to another market's price—say, the NYSE— as reflected in the NBBO). We started putting our listed orders into the system, and because of trade-throughs, we could not get some trades executed without compromise. As a result, Archipelago and Nasdaq built so-called whiner software (because we whined a lot). The "whine" is automatically triggered when (1) the public quote exceeds 100 shares at a price in the NBBO and (2) the order in Archipelago's ARCA book is at a superior price to the competing exchange and (3) the ARCA order is displayed for 15 seconds before a trade takes place at the inferior price in the NYSE and (4) the trade remains unexecuted for at least 10 seconds after the trade at the inferior price.

Whining is a frequent occurrence. The specialists believe the market resides with them, and an imputed belief is that the regional exchanges are not contributing to price discovery, which has, in fact, been true historically. Prior to decimalization, the regional exchanges were used primarily by retail firms, such as Charles Schwab & Company, to maximize profitability by routing orders and earning payment for order flow from the regional exchanges.

Since decimalization, the practice of payment for order flow appears to be breaking down, which has changed the economic structure of many order flow arrangements. Now, as real electronic orders flow through Nasdaq (and, soon, through the Pacific Coast Exchange), the NYSE is trying to make sure orders have to come to it. A good audit trail does not exist that reveals the primary exchanges' failure to recognize better prices on regional exchanges. But from mid-June through August 2001, Archipelago and Nasdaq recorded more than 1,500 NYSE whines a day, which is a big concern. It means that either the specialists cannot keep up with both an electronic market and a physical market, which is a reasonable explanation, or that they are ignoring the electronic market because they are granting free options to the floor crowd.

Until the market adjusts to a more integrated system, these whines have important implications for how managers manage, especially given the environment of 2–4 percent real expected stock returns suggested by Robert Arnott and Peter Bernstein[7] and the fact that the cost of trading is estimated to be 1–3 percent for small- and mid-cap stocks.

The impediments to trading are regulatory—that is, driven by market regulations designed to protect the owners of the marketplace. I am a big fan of Archipelago's move to partner with the Pacific Stock Exchange to form a new for-profit stock exchange. A for-profit stock exchange is not owned by intermediaries and not run for intermediaries; it is owned by and run for the stockholders.

[7]Robert D. Arnott and Peter L. Bernstein, "What Risk Premium Is 'Normal'?" *Financial Analysts Journal* (March/April 2002):64–85.

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Conclusion

The problems with achieving best execution cannot be separated from the existing economics of trading systems and the reluctance of traders and portfolio managers to change the way they approach the trading function. Roughly 65 percent of ECN users are broker/dealers and hedge funds and 25 percent are day traders. As I mentioned earlier, only about 7–8 percent of ECN users are on the buy side. Schwartz and Steil wrote:

> Survey results clearly suggest that the traditional explanation for immediacy demand . . . is overstated. We conclude that the buy side's demand for immediacy is in appreciable part endogenous to an intermediated environment that is characterized by front-running.

Although some may find this view to be too cynical, the statement summarizes the behavior and rationale that I have witnessed over the course of my career.

Is unbundling of commissions and research and other soft dollar services desirable and feasible? In the same Schwartz and Steil survey mentioned previously, they found that 51 percent of managers believe unbundling commissions from the research process is desirable and only 8 percent believe it is undesirable. The bundled process, however, has a major positive impact on the earnings stream of many investment managers.

In the United Kingdom, Paul Myners, chairman of the Gartmore Group and one of the most respected money managers in the United Kingdom, was asked to investigate the inefficiencies of capital formation for small- and mid-cap U.K. firms. One of the recommendations he made was that all commissions be paid by the manager out of the management fee. U.K. firms have been given two years to respond to and implement the recommendations.

Although such action is a long way off in the United States, in light of the SEC's direction and AIMR's new guidelines, U.S. firms should begin to address the following questions:

- Is the commission you pay really protected by the safe harbor? It probably is not safe at 6 cents, or even 5 cents.
- Do you use ECNs? When? How much? How do you make that choice? You must first give your traders permission to be traders.
- Do you pay the same brokerage rate to all vendors and the same rate on all trades? If so, why? Lower negotiated rates alone are not sufficient. The SEC is looking for some variance within the rates paid to the same broker among trades. Some firms are paying 2–3 cents for taking the other side of a trade and paying 6 cents for capital commitment. These investment management firms have a formula for determining what they pay for various kinds of trades.
- How do you measure best execution? Whether you use Capital Research Associates, Plexus Group (implementation shortfall methodology), or volume-weighted average price, part of the answer to achieving best execution lies in having a process to measure it.
- Have you invested in sufficient trading technology? Or are your traders bill-paying order clerks?
- Do you know where your orders go? The order execution process is, in my opinion, sausage making at its worst. It is where the source of performance resides, especially in a potentially low-return environment.
- Regarding step-outs, are the rates and best execution promises consistent with what your marketing agent tells the sponsor? A lot of firms use step-outs and think they are getting best execution by using them. But almost everybody I talk to on the sell side tells me they have an A list and a B list, and the firms that step out are on the B list. If you are calling a potential buyer with merchandise and you know there are three or four buyers around and you have a seller for something that is hot, you call the buyer that will maximize your income. You cannot maximize your income on that trade if 40 percent of the trade is going to be stepped out to a third party.

Attention to these issues will help firms get on the right track and avoid problems in the future.

The bottom line is that trading decisions are not driven simply by the search for best execution. Too many conflicting economic currents and motivations affect the execution decision, which more often than not is made by someone other than the trader. Paying up to execute is a function of the traditional and customary practice of buying broker services—research and market stability—with soft dollars, but this practice has been targeted by the SEC and industry standard setters (such as AIMR) as needing increased transparency and improved record keeping and accountability.

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Question and Answer Session

Harold S. Bradley

Question: Should soft dollars be outlawed?

Bradley: That is a complicated question. The answer is not simply yes or no, which is why the SEC changed the standard in 1986. It did not want to get into a categorical approval or denial of a specific use of soft dollars. As a firm, we have relied on the pre-1986 standard for a long time, which says that if a service is available for cash, pay cash. We think that practice is consistent with our clients' interests. Many smaller firms have said that they have to use soft dollars, which I would categorize as paying third parties for services that are allowed under Section 28(e). The real key to the appropriate use of soft dollars is commission rates, which explains why Levitt said 6 cents is not safe.

Question: What do you think about the AIMR soft dollar standards?

Bradley: AIMR has had a tough time establishing soft dollar standards because of the diversity of opinions in the business. What bothers me about the AIMR guidelines are the complex issues, such as mixed use. How am I going to audit and control whether 40 percent of my computer system is related to benefiting the investor? In addition, Section 28(e) gets a different spin when you have to answer Gohlke's question: Have you maximized the value of this trade decision? That's a far different question in terms of paying up than the old 28(e) safe harbor, which said you can pay up as long as you are benefiting your investor.

Question: How does ECN use affect how large-cap stocks or small-cap stocks are traded?

Bradley: We started relying on ECNs in 1992, and we've found tremendous value in using them for small-cap and illiquid securities. Telegraphing a 10,000-share order to a broker was far more damaging in those stocks than it was in, say, Microsoft. Using ECNs to trade in small-cap, illiquid stocks provides the most value because then people do not know who you are. With ECNs, you can disguise the size and reserve order requirements and control the market impact going in. Brokers don't commit their capital for free. When you give them a 10,000-share order on small-cap stock, they know they're going to lose money if they don't price it high enough.

Question: What is your opinion of the mergers, actual or potential, between the exchanges?

Bradley: Through my private equity activities, I have been close to Tradepoint in the United Kingdom and the Swiss exchanges. I was on the Tradepoint board and serve as an advisor to the Archipelago board. That said, I see these trends as an inevitable consolidation process that will affect both ECNs and exchanges.

Last week, Archipelago, by some measures the fourth largest ECN, announced a merger with REDIBook, the third largest ECN. REDIBook is owned by Spear, Leeds & Kellogg, or was until Goldman Sachs bought Spear Leeds in 2000. REDIBook is also owned by Charles Schwab and Fidelity. Archipelago is owned in part by J.P. Morgan Chase & Company, American Century, Merrill Lynch & Company, Goldman Sachs, and E*Trade.

A month ago Archipelago was granted stock exchange approval by the SEC and will be operational as a fully electronic stock exchange, the only one of its kind in the country. In merging with Archipelago, REDIBook is choosing to make a bet that it can produce a book for exchanges much like existing exchange structures in Europe, which provide limit order primacy, ease of entry and exit from the market, and multiple points of technology failure. This merger has major implications for both the Nasdaq and the NYSE, both of which have been slow in responding to some of the technological changes that threaten to remake the basic infrastructure at the management level and the trading level.

The biggest change in the next couple of years will be the payment structure. Decimalization is happening at the same time that commissions are starting to fall, so the Street is losing a primary source of revenue. The commission structure has been a major source of cross-subsidies, and its change will also have an impact on research, so it bears watching. This merger creates an interesting exchange opportunity.

Archipelago, a shareholder in Tradepoint, has also been engaged globally for some time, so electronic markets can be global. The problem in terms of cross-border investing is that the SEC's rules have kept foreign non-GAAP-denominated shares from being traded electronically in the United States. Ironically, I can call a broker to trade non-GAAP issues; I just cannot do it on a computer screen.

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Question and Answer Session

Harold S. Bradley

Question: How do you measure trading costs when Elkins/McSherry, Plexus Group, and others are using "fuzzy math" to calculate the costs?

Bradley: Elkins/McSherry is the biggest consultant in the VWAP (volume-weighted average price) measurement service. Generally speaking, its study of VWAP simply says if your buys are under the VWAP, that's good, and if your sells are over, that's bad. I think the VWAP mechanism is flawed; in fact, it is influencing price discovery processes in the market, and some dealers have even structured trades so that they look good in that study. A trader trying to "game" this system would simply stop buying shares of a large order if the day's price exceeds the trade-weighted price for the day. Many vendors report this price throughout the day. At its logical extreme, a trade that might be done in one day is stretched over several days if the price continues to trade higher. Several years ago, we had one trade that looked wonderful on a VWAP basis but was actually the worst when measured with the Capital Research Associates (CRA) market impact study.

Having been a portfolio manager, I know that the Plexus function is also troublesome because of difficulties in effectively capturing data. Plexus bases its analyses on the Perold implementation shortfall methodology, which tries to measure the implementation cost from the time a portfolio manager has the original trade idea, through the time the trader gets the order, to the time the order is executed, including the opportunity cost of cancelled orders.[1] The problem with this methodology is that a portfolio manager often "sits" on an analyst's recommendation or idea for a couple of days (or even weeks) as the portfolio manager considers the analysis in a market context. The portfolio manager often does not act on the analyst's recommendation until the stock starts to move and it looks as though the analyst was right. That kind of behavior might handcuff a trader asked to join the crowd. When did the portfolio manager really get the idea on which the Perold methodology is predicated? That's a difficult data-gathering problem. What is a fair measure? Many traders I know think that there should be more science behind the ability to capture the information on the front end. For most firms, that is a major potential flaw in the methodology, as I understand it.

At American Century, we like the market impact methodology used by CRA, which uses Gil Beebower's method of looking at day-after performance as measured against the market and industry groups. This technique contains biases and flaws, as well. None of these methods is perfect. Simply put, Beebower's method says that if you buy a stock over a period of five days and tomorrow it decreases more than its industry group sector, you suffer a positive trading cost or market impact. If the stock goes up more than the market or sector on the day following completion of the trade, you get credit for "negative" trading costs.

Question: How does Beebower's method of measuring trading costs differ from the other methods?

Bradley: The Beebower methodology tries to quantify a "rubber-band" effect that often occurs, what in trader slang is called "window shading." Wall Street's sell-side traders talk about the "window shade" of principal block trades. Many buy-side traders are not even familiar with the term. Let me try and explain: I sell 100,000 shares of a million share order to a broker's principal bid as that broker "gets me started." The broker uses his capital on the first part of the order and then widely communicates to other buyers that "he's long and working a big seller." The market will trade down to a clearing price, at which point the broker's phone rings off the hook. A typical buy-side trader doesn't want to look bad and might leave the broker instructions to "call me when the seller doesn't have any more (sell orders) behind." A good principal trader at the block-trading houses assesses the latent demand and knows when to bid the seller for big size at a dislocated price. He effectively pulls the window shade down and buys the rest of the block, cleaning up the seller. Then, the window shade snaps back with a vengeance as buyers are left with unfilled orders. The sell-side brokers are making calls to let the formerly cautious and patient buyers know that the seller is gone and the market "looks better."

This ritual dance raises costs to both sellers and buyers. The buyers now panic because they missed the best prices (but, of course, they're still under the VWAP!). The broker may stay "long on his book" maybe 200,000 shares that he sells into recovering prices; that is the only way he can fight back to even with that first badly priced 100,000 shares. So, what Beebower measures is a longer-term window shade.

[1] André F. Perold, "The Implementation Shortfall: Paper vs. Reality," *Journal of Portfolio Management* (Spring 1988):4–9.

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Again, I think that what happens in shorter time periods in the market also happens in longer time periods. Different ways to measure trading costs exist. Plexus and CRA at least use a standardized method across the industry, which allows a firm to evaluate its relative trading effectiveness. That is why we began using ECNs in the first place. The data were counter-intuitive, but we simply kept pushing the envelope as long as the data supported it, and we eventually became rabid sponsors of these new efficient electronic trading approaches because the data suggested we were removing significant trading costs from both easy and difficult trades.

Question: What would you estimate the Street's costs for basic brokerage to be—a penny a share? Why not separate research from execution; that is, write a check for research and pay a penny a share for execution?

Bradley: The real cost of execution is the ECN rate, not the cost of a heavily human-intermediated function. The ECN rate has been under a penny a share for a year. The agency broker rate, or the fully bundled rate, has been about 5 cents a share, but this rate is on the verge of being undercut for the first time in more than a decade.

In fact, over the years, we have been made aware that some brokers who would not budge on 5-cent bundled rates for American Century shareholders and clients would provide our clients a 1 cent or 2 cent rebate as part of a commission recapture program. In effect, they are saying to my client that the real cost of an agency execution is only 3 cents or 4 cents per share. That makes me irate: You are going to do cheaper business for my customer, whom I am trying to manage money for, but you are not going to give me that same rate? That is because there are two different operating subsidiaries for these firms trying to do the same business. These subsidiaries are in a price war within their own firms. The spread between the execution-only rate assessed by ECNs and the bundled rate for research, execution, liquidity, and other services is the effective payment rate for research, which I argue is near a historical wide point—about 4.25 cents.

The question I have is whether research is of more value today than it was before Regulation FD and the advent of Web-based systems that allow for an infinite number of participants on a company's earnings release conference call. I believe that some research and access to specific research analysts may well be worth this 28(e) investment (the so-called safe harbor in federal securities legislation that allows for an investment firm to "pay up" for research that benefits a fund's shareholders). That is why I believe so strongly in what StarMine is trying to do. StarMine has created a four star system to evaluate which analysts in which stocks are courageous, right, and early. StarMine is attempting to provide a quality brand, and I am willing to pay for a product that is valuable.

Regarding the question of unbundling, the Street is afraid that they will not be paid enough. This concern has major implications for how firms structure and conduct business. I argue that there is value to be had, but you have to know how to find it. So, I am investing in such companies as StarMine to try to brand some of this research as valuable for investors who really think and are not afraid to be different from the crowd.

Question: Are ECNs effective on short sales?

Bradley: ECNs are awesome on short sales. ECNs have always allowed for trading in increments of 1/256th. So, even as people argued over decimals on the Nasdaq and NYSE, you could regularly trade in 64ths, 128ths, and 256ths on Instinet, Archipelago, Bloomberg, and other ECNs. A decimal is a fraction, after all; ECNs simply split the 8th to infinity.

Hedge funds have been big users of short-selling strategies on ECNs for a long time for this reason. When the market was a fixed-eighth market five years ago, a hedge fund could go into an ECN up 1/32nd or 1/64th and get off a short that was on an uptick, not recognized on the public tape. And by using smaller orders, I found that the efficacy of my short selling on the Nasdaq was far superior in terms of time of execution, percentage of fulfilled orders, and price impact than it was on the NYSE, where I had a much higher opportunity cost for unfilled orders and a much longer duration before execution.

Question: Do you expect the impact of Nasdaq's SuperMontage on ECNs to be positive or negative?

Bradley: A huge change is under way. I was invited to participate on a Federal Advisory Committee by Chairman Levitt before he left the SEC, and we looked at the pricing mechanisms for the exchanges. Not many people clearly understand regulatory funding mechanisms and the significant income that exchanges derive from sharing tape print revenues. For every trade printed on what is called the "consolidated tape," the exchanges get paid. When the plan for sharing tape print revenues was established in the late 1970s, it was intended to fund the exchanges' self-regulation costs. I am told that those "plans" have become a major source of exchange revenue and marketing budgets.

Recently, however, Island ECN, now the largest ECN, made a deal with the Cincinnati Stock Exchange; the exchange will share revenues with Island for all trades printed on the exchange. Also, Archipelago acts as a facility for the

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Pacific Coast Stock Exchange (PCX) and is in the process of turning the exchange into a fully electronic exchange. Archipelago wants the regulatory status and the ability to be a member of "the club" that the exchange can bestow. By belonging to the club, Archipelago gains a share of tape revenues; so, every trade that gets printed on the PCX will bring in revenue for Archipelago.

When Island did its deal with the Cincinnati Stock Exchange, Island was one of Nasdaq's biggest customers. If Island is now going to print and show all its business through Cincinnati because of the revenue arrangement, that is about 20 percent of the daily trading volume of the Nasdaq stock market. Archipelago and REDI (who recently merged) represent a large percentage of the Nasdaq stock market trading volume, and Archipelago now is going to be doing the same thing on the PCX. Therefore, I see equalization and competition based on the "revenue and trade print revenue" screen. The details of this change may seem arcane and complicated, but the change is interesting because billions of dollars are at stake.

Question: Do brokerage firms take advantage of buy-side order flow? If so, how?

Bradley: Of course brokerage firms take advantage of buy-side order flow. They are intermediaries. Some firms take advantage of it proprietarily, but not all firms do. The real issue is how brokerage firms take care of their customers and what kind of customers they have. For example, floor constituents from the NYSE have asked me to try and bring attention to a large hedge fund and its relationship with Wall Street because they are convinced this fund pays as much as 15 cents a share simply to find out where big orders are from other customers. There are many different ways—with revenue streams that are opaque—to leverage and harness operating margin and relationships. That is why anonymity is so important.

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Question and Answer Session

Harold S. Bradley

Question: How many trades can a trader work on ECNs?

Bradley: The number depends on whether the trader has spent any money developing technology or whether the trader wants the ECN to work the business, which is how a lot of people deal with Instinet. Instinet Corporation didn't start out with a roomful of traders, but it has them now because the buy side would not build the appropriate infrastructure.

At our trading desk, when I started in 1990, we had about six traders. The firm is now 10 times bigger, but we nevertheless have only about 14 traders because of our efficient infrastructure. We have a lot of internal systems in place to monitor the trading of our brokers. Depending on how active and volatile a stock is, a good trader can handle six to eight stocks at one time, just as a good broker can handle six to eight stocks. If you are not a good trader, you cannot handle nearly that many.

Question: What percentage of your firm's trades require broker capital to get them started?

Bradley: Using broker capital to get a trade done rarely works. Instead, it becomes a huge cost. We can go to ECNs and hit the buttons. The trades we're not doing on ECNs are those for which our FIX indications tell us a natural is on the other side. We have built the systems to try to see through the need to go to a broker.

The only time we use capital is to create an advertisement. The problem is that the risk-adjusted price makes the advertisement far less efficient than simply going to the floor of the NYSE and letting the crowd spread the word in two minutes.

Question: Do you use ECNs and brokers simultaneously?

Bradley: No, using ECNs and brokers at the same time would be imprudent. A trader uses an ECN for anonymity and control of the order. When you're using an ECN on a big block, if a broker calls, the broker can figure out what you're doing, and the value to the broker lies in controlling what you're doing. So, we would typically not respond to a broker about an order we were working on an ECN.

We believe that doing business the right way should lower costs. Brokers know when you're doing things in two places; they know exactly what you are doing and where because they call each other. In fact, a network has been established of calls that are made to certain hedge funds—the information-clearing people. When brokers know what you are doing, your cost of capital with those brokers will rise. They know that if you are going to beat the bids out on Instinet, Archipelago, or Bloomberg, you are compromising them. It is also a question of right and wrong. Going to ECNs and brokers at the same time may seem expedient, but it raises your cost of doing business and is not ethical.

Question: What do you think of blind principal bids transferring the risk to the broker?

Bradley: Programs are a different animal altogether from individual stock transactions because programs are affected by portfolio construction issues, such as beta, volatility, and liquidity. The ability to access that principal bid on a block of stocks does transfer significant execution risk, but it's good only up to a certain size. If the broker chooses to accept risk in that case, it can be hedged.

Question: What is the perfect scenario for trading?

Bradley: I am a huge believer in the need for a central limit-order book (CLOB) with price/time priority and electronic access and egress. It would allow people to be paid for wisdom and knowledge and for putting a price on an idea, not for how well they can transfer information about one client's intentions to another. The problem with creating a CLOB is that New York says, "We'll build and own it." I say, "No way!" In an ideal world, Cisco Systems would build and own it. The trading cost would be the bandwidth charges, not the economic rents charged for intermediating on behalf of the members. That kind of system is the stuff of dreams.

What I would settle for is that best execution would truly matter to everyone. I work for a firm that is aligned with the idea that best execution does matter. Best execution is an ethical issue. Legal is always mentioned in the same breath as ethical, but legal is what you can do and not go to jail; ethical is what you should do.

I also dream about making the trader a professional and integral part of the investment process. It can be done at any firm. If all the trader is doing is handing orders off to a broker, he or she is not valuable and may be easily replaced. But if a trader is adding value to the investment process and helping generate returns or

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reduce costs (which, over time, generates returns), the trader is valuable. We believe ECNs saved us $220 million last year, but bucking historical practices requires courage. Most of us were trained and educated by brokers about how to do our business. Traders seem to be afraid to be valuable.

Question: How do you think a firm should handle step-outs? What is the maximum?

Bradley: Traders tell me there's no way they can do ECN business because they have way too many step-outs. It's a nightmare. They have to pay too many bills. Virtually every trader I know feels impaired by this practice, and I think when you feel impaired, you've hit your maximum.

Step-outs are one way to use client commissions to pay your firm's bills. If the manager can't survive on the management fee, however, then the manager shouldn't be in the business. Trading commissions are supposed to be used to facilitate execution and the other services we are willing to pay for. So, the question becomes whether stepping out is right. Step-outs happen because best execution is a threat.

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Appendix B

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The Disgrace of Soft Dollars

Investment funds are secretly lining their pockets by inappropriately charging billions of dollars' worth of expenses to investors. These "soft-dollar" arrangements allow managers to overpay in brokerage commissions in exchange for research, office space, magazine subscriptions, etc. -- with shareholders unwittingly footing the bill. With scandals rocking the industry, now is the time for mutual funds and hedge funds to correct their ways voluntarily -- or have it done for them.

By Whitney Tilson
March 19, 2004

Massachusetts Financial Services Co. (MFS), the oldest and 11th-largest mutual fund company, announced this week that it has stopped paying brokers in "soft dollars." I can hear the yawns across America, but this is an important issue because investors are being bilked out of billions.

Soft dollars (don't you love such benign-sounding euphemisms?) are excess trading commissions that funds pay to brokerage firms, which are then rebated to the funds in the form of investment research and software, Bloomberg terminals, magazine subscriptions, office space, and the like. These are expenses that in almost all cases would be paid for by the fund out of its management fee income, but instead are shifted to the fund's investors via inflated trading costs.

These costs are especially insidious because they're nearly invisible. Do you know how much your mutual funds spent last year on trading costs and commissions? Would you know how to find this information? According to an excellent column on high fund costs by fellow Fool Robert Brokamp, "To find out how much a fund pays its broker -- money that comes straight out of the fund shareholders' pockets -- an investor must dig through the fund's Statement of Additional Information, which is filed with the SEC, or the semi-annual filing of form NSAR. Raise your hand if you've heard of these documents."

In short, the general counsel of mutual fund giant Fidelity was exactly right when he admitted that soft-dollar payments are among the "least visible" and "least understood" expenses for investors.

Soft dollars in practice
To see how soft dollars work, let me tell you about my recent experiences looking for office space in Manhattan. A good setup for four to five people can cost as much as $10,000 per month, which is a significant cost for a small money-management firm like mine. I can cut this cost substantially, however -- perhaps by $5,000 per month -- if I agree to do enough trading at full brokerage commissions with certain firms that have office space available.

Here's how the math works: If I pay six cents per share commission rather than the two cents I might otherwise pay, the broker pockets an extra four cents per share. If I buy or sell only 125,000 shares each month with the broker, the extra four cents adds up to $5,000, which the broker returns to me via a break on my rent.

As with most funds, the partnership agreements that govern my funds explicitly permit soft dollars, and I certainly have strong incentives to use them since every dollar I save on rent is one more dollar of pretax profit.

So why am I not leaping at a soft dollar-subsidized rent deal? Because I'd be screwing my investors! They already pay me a 1% management fee, which is supposed to cover all of my expenses. Paying inflated commissions so that my broker will pay expenses like rent (or a Bloomberg terminal, third-party research, etc.) would simply be shifting costs that are supposed to be paid out of the management fee to my investors in the form of hidden, extra commission charges.

I won't go so far as to call using soft dollars stealing -- as discussed below, it's typically disclosed, at least in the fine print -- but it's pretty darn close.

Billions at stake
Lest you think this is a minor issue in the grand scheme of things, think again. An article in *The Wall Street Journal* this week reported that "Mutual funds and other institutional investors paid about $12.7 billion in commissions in 2002, about half of which was compensation for research and other forms of soft-dollar services, according to the latest numbers from research firm Greenwich Associates." Another study showed that commissions were inflated to an even greater degree. Richard Strauss of **Deutsche Bank** (NYSE: DB) concluded that 40% of the commission paid by a fund company relates to research, 45% to execution, and the rest (15%) goes to third-party research and computer aids.

This is consistent with back-of-the-envelope math: Funds pay an average of five cents per share commission at the major brokerage houses, yet according to another *Wall Street Journal* article, "Most Wall Street firms acknowledge that only about two cents [e.g., 40%] of the standard five-cent commission goes toward trading execution."

This adds up to big numbers. If half of the $12.7 billion in commissions paid by mutual funds (not even counting the billions generated by hedge funds) are used to pay for research and other services that should be paid from management fees, then mutual fund investors are paying roughly *$6.3 billion* that they shouldn't be! That's about $21 for every man, woman, and child in this country. As I was saying, big numbers...

It's easy to see why money-management firms are reluctant to get off this gravy train. MFS estimates that its new policy will cost it $10 million to $15 million per year, and Fidelity, the largest fund company in the country, estimates that it pays about $275 million annually in soft-dollar research.

The excuses
The fund industry does try to defend these soft-dollar arrangements. Here are the four biggest rationalizations I've heard:

1. Research benefits investors
The most common defense of soft dollars is that they are mostly used to pay for research and information services that help fund managers make better investment decisions, which in turn benefits shareholders. I have two problems with this argument. First, I question whether Wall Street research helps managers generate better returns (in fact, I think most of it is worse than useless, but I'm hardly an expert since I almost never read it).

But my main objection is who ends up paying. If a fund manager believes that access to certain research (or a Bloomberg terminal, etc.) will result in superior investment returns, then he/she should by all means pay for it -- but this is precisely the type of expense that should be paid for *out of the management fee*!

2. It's disclosed
Another defense of soft dollars is that their use is disclosed in fund prospectuses. My answer: So what? Does anyone really read those dense documents? Even if investors did, how many would have

the foggiest notion what soft dollars were? The reality is that the overwhelming majority of investors have no idea that they're in effect being charged a significantly higher fee than they think.

3. It's OK to pay for good execution
A recent article in *Barron's* defended soft dollars by arguing that in the case of big trades by large funds, "Unless the executing broker takes great care to disguise the underlying source and character of the trade, the dilution of portfolio returns from price impact can overwhelm any savings from low-cost brokerage services. Investors are better off if the manager pays the broker a higher commission to take greater care in executing trades."

Well, no kidding, but what does this have to do with soft dollars? In some cases, when I have a difficult order in which a trader might spend days carefully buying an illiquid stock without running it up (or selling it without crashing it), I'm quite happy to pay a higher commission than usual. But this has nothing to do with soft dollars or expenses that would otherwise be paid for out of my management fee.

4. That's the way it's always been done
When all the rationalizations are stripped away, the only defense I hear is that "this is the way it's always been done, and everyone else does it." Sorry, but that's not good enough for me -- and it shouldn't be for you either.

An analogy
Here's the question I would pose to any fund-management company that uses soft dollars. Let's say your funds' auditor came to you and whispered, "Psssst! Instead of paying me the usual $1 million this year to audit all of your funds, instead pay me $2 million. [Audit expenses, like commissions, are typically paid by the fund, not out of the management fee.] Then, I'll give you a $900,000 credit that you can use to pay for pretty much whatever you want related to your business: a research analyst that we'll hire so you don't have to, office space, etc."

I think any self-respecting fund-management company would be outraged and immediately reject such an offer. Yet I see no difference between this and the current soft-dollar system -- other than the starting point (e.g., the soft-dollar gravy train is already well established), which is what humans naturally anchor on, especially when it is in their self-interest to do so.

Conclusion
So what can you do about this? First, call your money managers and ask if they use soft dollars and what they pay, on average, in commissions. If the answers are yes and/or more than three cents per share (unless there's a really good explanation for paying more), tell them that you object to soft dollars and/or paying high commissions in exchange for research and threaten to close your account.

Second, some firms do not use soft dollars -- for example, Vanguard never has, and now MFS doesn't -- so consider investing your money with such firms. Finally, contact your senator and congressperson. A mutual fund bill that cleared the U.S. House of Representatives last year would require greater disclosure of soft-dollar arrangements while a bill introduced in the U.S. Senate would ban them altogether. Neither bill appears likely to pass, given the lobbying clout of the investment-management industry, so phone calls could help a lot.

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Whitney Tilson is a longtime guest columnist for The Motley Fool. Under no circumstances does this information represent a recommendation to buy, sell, or hold any security. Mr. Tilson appreciates your feedback at Tilson@Tilsonfunds.com. To read his previous columns for The Motley Fool and other writings, visit http://www.tilsonfunds.com/. The Motley Fool is investors writing for investors.

PREPARED STATEMENT OF GEOFFREY I. EDELSTEIN, CFA, CIC

MANAGING DIRECTOR, WESTCAP INVESTORS

ON BEHALF OF THE

INVESTEMENT COUNCIL ASSOCIATION OF AMERICA

MARCH 31, 2004

Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee, I greatly appreciate the opportunity to appear before you today to address issues related to soft dollars. On behalf of the Investment Counsel Association of America (ICAA), I wish to commend the Committee for convening this and other hearings on issues related to current investigations and regulatory actions regarding the mutual fund industry.

I am a Managing Director and Co-Founder of Westcap Investors, LLC, an investment advisory firm located in Los Angeles, California. Westcap was founded in 1992 and is registered as an investment advisory firm with the Securities and Exchange Commission.[1] Our firm provides investment advisory services to both individuals and institutions. Our clients include a wide variety of individual investors as well as pension and profit sharing plans, charitable organizations, corporations, State and municipal government entities, and pooled investment vehicles, such as limited liability companies and mutual funds (as a subadviser). Today, our firm employs 43 people and is majority-owned by its employees. Westcap's current assets under management total about $2.8 billion.[2]

The Investment Counsel Association of America[3] is a nonprofit organization based in Washington, DC that represents the interests of SEC-registered investment advisory firms. Westcap has been a member of this organization for many years and I am pleased to offer my testimony today on behalf of the ICAA. A statement on soft dollars that was released by the ICAA earlier this month is included as part of my statement.

Summary of Positions

- Investment advisers are fiduciaries and, as such, have an obligation to seek best execution in connection with client transactions and to disclose potential conflicts of interests to both existing and prospective clients. Client brokerage is an asset of the client—not of the adviser, and thus there is a potential conflict where an adviser uses client brokerage for research. Accordingly, the ICAA supports full and appropriate disclosure of soft-dollar practices by all investment advisers. Consistent with the basic approach of U.S. securities laws and market principles, we strongly believe that the SEC should ensure that there is adequate disclosure about soft-dollar practices, combined with appropriate inspection and enforcement of regulations governing these practices.
- The ICAA fully supports the SEC's current initiative to examine soft-dollar practices. Specifically, the ICAA believes the SEC should conduct a rulemaking aimed at ensuring that required disclosures related to soft-dollar arrangements are adequate and appropriate and to clarify the current definition of "research." The consequences of abolishing soft dollars—an outcome that would require Congressional action—likely will adversely affect smaller investment advisory firms, create entry barriers for new investment advisory firms, and diminish the quality and availability of proprietary and third-party research. Consequently, the ICAA strongly believes that a rulemaking is the best option for considering and implementing changes in this important area.
- The ICAA supports appropriate recordkeeping requirements for investment advisers regarding soft-dollar transactions. Investment advisers should maintain appropriate documentation of soft-dollar transactions, the services received, their uses, and allocation methodologies for mixed-use items (a service or product that provides both research and other uses). In addition, the ICAA believes that investment advisers should develop and implement appropriate internal controls and

[1] Section 202(11) of the Investment Advisers Act of 1940 defines an investment adviser as "any person, who, for compensation, engages in the business of advising others . . . as to the value of securities or as to the advisability of investing in, purchasing, or selling securities. . ." This section also sets forth several exceptions to the definition.

[2] As with all other SEC-registered investment advisers, Westcap's Form ADV Part 1 is publicly available on the Investment Adviser Public Disclosure website: *www.adviserinfo.gov.* This required registration and disclosure form provides information about an investment advisory firm, its principals, its clientele, any disciplinary history, and various activities.

[3] The ICAA's membership consists of more than 300 SEC-registered investment advisory firms that collectively manage in excess of $4 trillion for a wide variety of individual and institutional clients. For more information, please visit: *www.icaa.org.*

procedures that are designed to ensure that soft-dollar arrangements are supervised, controlled, and monitored.

- As set forth in the ICAA's March 3 statement, however, we oppose the suggestion that the SEC should eliminate the use of soft dollars for third-party research. We believe this approach would harm investors and diminish the availability of quality research. It would result in an unjustifiable, unlevel playing field for many market participants. It would provide a regulatory-driven advantage for full-service brokerage firms and disadvantage third-party research providers. Ironically, eliminating soft dollars for third-party research also would result in less transparency to investors, regulators, and market participants.

Profile of the Investment Advisory Profession

The profile of the investment advisory profession is often mischaracterized and misunderstood. Investment companies (mutual funds) and the investment management companies that provide investment advice to mutual funds constitute a significant and important part of the investment advisory profession. However, mutual fund companies and their advisers comprise only a portion of the entire investment advisory profession. In fact, statistics indicate that the vast majority of SEC-registered investment advisory firms are small companies and that most of them do not manage mutual funds.

Beginning in 2001, investment advisers have been required to use an electronic filing system—the Investment Adviser Registration Depository (IARD)—when submitting Form ADV, Part 1, the basic registration and disclosure document required by the SEC.[4] Since then, the ICAA and National Regulatory Services have issued annual reports profiling the investment advisory profession based on these required filings. In 2003, we reported that there were a total of 7,852 entities registered with the SEC as investment advisers. Of this total, 5,299 (67.5 percent) reported having 10 or fewer employees. On the other end of the spectrum, only 260 (3.3 percent) of all SEC-registered investment advisory firms reported that they employ more than 250 persons. And only 1,478 (less than 20 percent) of all SEC-registered investment advisers reported that they provide portfolio management for mutual funds (investment companies).[5]

While a relatively few large firms dominate the investment advisory profession in terms of their collective assets under management, the fact remains that most investment advisory firms are small businesses that are extremely diverse, both in terms of the investment services they provide and the extremely wide range of investors they serve. We submit that this fact should be considered carefully in making any significant regulatory or policy decisions that affect investment advisers.

Definition of Soft Dollars/Proprietary vs. Third-Party Research

The subject of today's hearing is often misunderstood and controversial, in part due to the unfortunate term, "soft dollars." Soft dollars simply refers to the provision by broker-dealers of research in addition to execution of securities transactions in exchange for commission dollars. The SEC staff has described soft-dollar arrangements as follows:

> Research is the foundation of the money management industry. Providing research is one important, long-standing service of the brokerage business. Soft-dollar arrangements have developed as a link between the brokerage industry's supply of research and the money management industry's demand for research. Broker-dealers typically provide a bundle of services including research and execution of transactions. The research provided can be either proprietary (created and provided by the broker-dealer, including tangible research products as well as access to analysts and traders) or third-party (created by a third party but provided by the broker-dealer). Because commission dollars pay for the entire bundle of services, the practice of allocating certain of these dollars to pay for the research component has come to be called "softing" or "soft dollars." [6]

As noted in the SEC's report, soft-dollar arrangements generally can be categorized as either "proprietary" or "third party." When the broker-dealer that executes a trade also provides internally generated research in exchange for one

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[4] In general, any investment adviser that manages in excess of $25 million must file Form ADV, Part 1 via the IARD system.

[5] *Evolution/Revolution: A Profile of the U.S. Investment Advisory Profession,* Investment Counsel Association of America and National Regulatory Services (May 2003). The report is posted on the ICAA's web site: *www.icaa.org.*

[6] *Inspection Report on the Soft-Dollar Practices of Broker-Dealers, Investment Advisers and Mutual Funds,* The Office of Compliance Inspections and Examinations, U.S. Securities and Exchange Commission (September 22, 1998).

bundled commission price, that arrangement is referred to as "proprietary." This is often also referred to as "Wall Street research." Wall Street, or full-service brokerage firms, will not break out the costs to purchase these proprietary services "à la carte" to the vast majority of its clients. Instead of proprietary research, however, the executing broker can provide independent research generated by third parties in exchange for commission dollars. In these instances, the executing broker must be obligated to pay for the third-party research provided to the investment adviser in order for the arrangement to fall within the 28(e) safe harbor. These "third-party" arrangements are an important mechanism for the distribution of independent research and analytic services.

Several issues are raised by soft-dollar arrangements. First, the commissions used for execution and research services are paid by the investment advisers' clients. As such, an investment adviser has the obligation to use these commissions in the best interests of its clients and consistent with its fiduciary duties. Second, because proprietary research is bundled with execution services, the costs of research, execution, and other services are not as transparent as they would be if charged separately. Third, the definition of what is allowable research has been blurred as new products and services are created, particularly those using various technological innovations. Ultimately, we believe these issues are best addressed by ensuring that investors receive full and accurate disclosure of soft-dollar arrangements; by clearly delineating the types of research services that are eligible in such arrangements; and by giving the SEC appropriate tools and resources for inspection and enforcement activities.

Fiduciary Duty

Investment advisers are subject to a fundamental fiduciary duty. This duty has been upheld by the U.S. Supreme Court[7] and reiterated by the SEC in various pronouncements over the years.[8] As described in the following excerpt, an investment adviser's fiduciary duty is one of the primary distinctions between investment advisers and others in the financial services industry:

> As a fiduciary, an adviser owes its clients more than honesty and good faith alone. Rather, an adviser has an affirmative duty of utmost good faith to act solely in the best interests of the client and to make full and fair disclosure of all material facts, particularly where the adviser's interests may conflict with the client's. Pursuant to this duty, an investment adviser must at all times act in its clients' best interests, and its conduct will be measured against a higher standard of conduct than that used for mere commercial transactions.[9]

Among obligations that flow from an adviser's fiduciary duty are: (1) The duty to have a reasonable, independent basis for its investment advice; (2) the duty to seek best execution for clients' securities transactions where the adviser is in a position to direct brokerage transactions; (3) the duty to ensure that its investment advice is suitable to the client's objectives, needs, and circumstances; (4) the duty to refrain from effecting personal securities transactions inconsistent with client interests; and (5) the duty to be loyal to clients.[10]

Since it was founded in 1937, the ICAA has emphasized an adviser's fiduciary duty as a cornerstone of an investment adviser's obligations.[11] In the soft-dollar context, we believe that fiduciary principles require an investment adviser to make appropriate disclosure to their clients about soft-dollar practices. Appropriate disclosure will allow investors to make informed judgments about such practices based

[7] *SEC* v. *Capital Gains Research Bureau,* 375 U.S. 180, 186 (1963).

[8] *See, for example, In re: Arleen W. Hughes,* Exchange Act Release No. 4048 (February 18, 1948). "The record discloses that registrant's clients have implicit trust and confidence in her. They rely on her for investment advice and consistently follow her recommendations as to the purchase and sale of securities. Registrant herself testified that her clients follow her advice 'in almost every instance.' This reliance and repose of trust and confidence, of course, stem from the relationship created by registrant's position as an investment adviser. The very function of furnishing investment counsel on a fee basis—learning the personal and intimate details of the financial affairs of clients and making recommendations as to purchases and sales of securities—cultivates a confidential and intimate relationship and imposes a duty upon the registrant to act in the best interests of her clients and to make only recommendations as will best serve such interests. In brief, it is her duty to act in behalf of her clients. Under these circumstances, as registrant concedes, she is a fiduciary; she has asked for and received the highest degree of trust and confidence on the representation that she will act in the best interests of her clients."

[9] Lemke & Lins, *Regulation of Investment Advisers,* at p. 174 (2003).

[10] *Id.*, at p. 175.

[11] "An investment adviser is a fiduciary and has the responsibility to render professional, continuous, and unbiased investment advice oriented to the investment goal of each client." *ICAA Standards of Practice.*

on all relevant facts. In addition, fiduciary principles require investment advisers to make trade execution decisions in the best interests of their clients in light of relevant facts and circumstances.[12]

Disclosure and Transparency

Disclosure is a bedrock principle of the U.S. securities laws. As a general matter, in fulfilling its fiduciary obligations to clients, an investment adviser is required to make full and fair disclosure of all material facts necessary for informed decision-making by clients, particularly where a potential conflict of interest is involved.

One of the primary disclosure tools required of investment advisers is Form ADV, Part II, or the so-called "brochure." The brochure is the key disclosure document that all investment advisers must deliver to existing and prospective clients (and offer to clients each year).

In the soft-dollar context, Form ADV, Part II requires investment advisers to disclose information related to brokerage and commissions. Specifically, Item 12 requires disclosure regarding whether: (a) The adviser or a related party has authority to determine, without specific client consent, the broker-dealer to be used in any securities transaction or the commission rate to be paid, and (b) the adviser or a related party suggests broker-dealers to clients. If the adviser engages in either of these practices, it is required to describe the factors considered in selecting broker-dealers and in determining the reasonableness of commissions charged. If the value of research products or services given to the adviser or a related party is a factor in these decisions, the adviser must describe the following:

- The research products and services;
- Whether clients may pay commissions higher than those obtainable from other broker-dealers in return for these products and services;
- Whether research is used to service all of the adviser's clients or just those accounts whose commission dollars are used to acquire research products or services; and
- Any procedures the adviser has used during the past fiscal year to direct client transactions to a particular broker-dealer in return for research products or services.

The SEC has proposed enhancements to these soft-dollar disclosures by investment advisers. While the proposal has not yet been finalized, the ICAA anticipates final action later this year. Following is an excerpt from the SEC's regulatory proposal that describes these enhancements (all footnotes omitted):[13]

> *Soft-Dollar Practices.* Advisers often receive "soft-dollar" benefits from using particular brokers for client trades. Client brokerage, however, is an asset of the client—not of the adviser. When, in connection with client brokerage, an adviser receives products or services that it would otherwise have to produce itself (or pay for), the adviser's interest may conflict with those of its clients. For example, soft-dollar arrangements may cause an adviser to violate its best execution obligation by directing client transactions to brokers who are not able to adequately execute the transactions, or may give the adviser incentive to trade client securities more often than it would absent the benefits the adviser receives. Because of these conflicts, we have required advisers to disclose their policies and practices on use of client brokerage to obtain soft-dollar benefits.
>
> During 1997–1998, our staff conducted a wide-ranging examination of advisers' soft-dollar practices and disclosure. Our Office of Compliance Inspections and Examinations found widespread use of soft dollars by investment advisers that manage client portfolios. The Office concluded that advisers' disclosure often failed to provide sufficient information for clients or potential clients to understand the adviser's soft-dollar practices and the conflicts those practices present. In its report, the Office noted that most advisers' descriptions were simply boilerplate, and urged that we consider amending Form ADV to require better disclosure. Today we are acting on those recommendations.
>
> Item 11 would require an adviser that receives research or other products or services in connection with client securities transactions (soft-dollar benefits) to disclose the adviser's practices and discuss conflicts of interest that result. The brochure's description of soft-dollar practices must be specific enough for clients to understand the types of products or services the adviser is acquiring and per-

[12] *Interpretive Release Concerning the Scope of Section 28(e) of the Securities Exchange Act of 1934 and Related Matters,* Exchange Act Release No. 23170 (April 23, 1986).

[13] *Electronic Filing by Investment Advisers; Proposed Amendments to Form ADV,* Advisers Act Release No. 1862 (April 5, 2000).

> mit them to evaluate conflicts. Disclosure must be more detailed for products or services not used in the adviser's investment decisionmaking process.
>
> Item 11 would describe the types of conflicts the adviser must disclose when it accepts soft-dollar benefits, and require the adviser to disclose its procedures for directing client transactions to brokers in return for soft-dollar benefits. The item would require the adviser to explain whether it uses soft dollars to benefit all clients or just those accounts whose brokerage "pays" for the benefits, and whether the adviser seeks to allocate the benefits to client accounts proportionately to the brokerage credits those accounts generate. The item would also require the adviser to explain whether it "pays up" for soft-dollar benefits.

These enhanced disclosures will put more detailed information in the hands of clients, permitting clients to decide whether they approve of their advisers' use of their commissions.

In addition to disclosure and other regulatory requirements, there are a number of market factors that play a significant role in soft-dollar arrangements. For example, many investment advisory clients (or their consultants) request and receive extensive information relating to soft-dollar practices. These requests often extend to information that go beyond disclosures required by regulations, including specific client information. The fact of the matter is that investment advisers often supply a great deal of information regarding soft-dollar practices in response to requests from clients or their consultants.

Similarly, it should be recognized that excessive trading or paying excessive commissions to "earn" soft-dollar credits for research takes an adverse toll on an investment adviser's investment performance (by creating additional trading costs that must be deducted from any appreciation in value of a client's account). This fact alone serves as an important "market" deterrent from abusing soft-dollar arrangements. Investment performance is clearly the single most significant factor that investors (and their consultants) use to hire or fire an investment adviser. Accordingly, investment advisers whose clients are able to monitor their portfolios and investment performance will be sensitive to potential negative effects that may follow from trading activities associated with soft-dollar arrangements. In addition, clients (including mutual fund directors) receive independent custodial reports and can judge for themselves the appropriateness of commissions paid and the turnover of securities in their portfolios.

The ICAA supports full and appropriate disclosure of soft-dollar practices by all investment advisers. Consistent with the basic approach of U.S. securities laws and market principles, we believe that the SEC should ensure that there is adequate disclosure about soft-dollar practices, combined with appropriate inspection and enforcement of such regulations.

Definition of "Research"

Section 28(e) of the Securities Exchange Act of 1934 was enacted by the Congress in 1975 following the abolition of fixed commission rates. The section provides that: "no person . . . in the exercise of investment discretion with respect to an account shall be deemed to have acted unlawfully or to have breached a fiduciary duty under State or Federal law . . . solely by reason of his having caused the account to pay a member of an exchange, broker, or dealer an amount of commission for effecting a securities transaction in excess of the amount of the commission another member of an exchange, broker, or dealer would have charged for effecting that transaction, if such person determined in good faith that such amount of commission was reasonable in relation to the value of the brokerage and research services provided by such member, broker, or dealer, viewed in terms of either that particular transaction or his overall responsibilities with respect to the accounts as to which he exercise investment discretion."

In order to rely on the safe harbor under Section 28(e), an investment adviser must satisfy the following conditions:

- The adviser must be supplied with "brokerage and research" services;
- The services must be "provided" by a broker-dealer;
- A "broker-dealer" must be the provider of the service;
- The investment adviser must have "investment discretion" in placing the brokerage;
- The commissions paid must be "reasonable" in relation to the services provided;
- "Commissions" must be used to purchase the services; and
- The brokerage commissions paid must relate to "securities transactions."

One of the most important aspects of the safe harbor is the definition of "research" services. The leading pronouncement on this issue is the SEC's 1986 interpretive release. According to the 1986 release, the test for determining "whether

something is research is whether it provides lawful and appropriate assistance to the money manager in the performance of his decisionmaking responsibilities."[14] The SEC noted that what constitutes lawful and appropriate assistance "in any particular case will depend on the nature of the relationships between the various parties involved and is not susceptible to hard and fast rules." In later decisions, the SEC has noted that "research" does not cover a wide variety of expenses, including overhead (such as office rent, utilities, and salaries), administrative expenses, exam review courses, association membership dues, electronic proxy voting services, consulting services designed to assist an investment adviser in client marketing, legal expenses, accounting and tax software, as well as items such as travel, meals, hotel, and entertainment expenses associated with attending a research seminar or conference.[15]

The 1986 interpretive release specifically identified so-called "mixed-use" products and services that may have both research and nonresearch purposes. Among such mixed-use products are: Computer equipment used for research undertaken on behalf of clients and for nonresearch functions, such as bookkeeping or administrative operations; quotation systems that provide information pertinent to the valuation of securities while facilitating the adviser's reports to clients; and information management systems that integrate trading, execution, accounting, recordkeeping, and other administrative functions. The SEC requires investment advisers that receive a mixed-use product or service to make a reasonable allocation of the cost of the product or service according to its use.

Since the enactment of Section 28(e) in 1975, investment advisers have begun to use investment styles that require quantitative analytic tools that are in some ways quite different from the traditional research tools used by investment advisers. In addition, the way that research is delivered has significantly changed since 1986, when the SEC last defined "research." The predominant form of research in 1975—paper documents covering one issuer—have now developed into a myriad of research services, including electronic delivery and software that provides consolidations of research covering entire sectors, industries, and other categories into searchable, analytical databases. These changes have presented many challenges for advisers attempting to interpret the SEC's guidance from 1986.

The ICAA supports the SEC's efforts to ensure that soft dollars are used only for legitimate research purposes. We also recognize the difficult challenges associated with this task. Particularly given advances in technology, including communications and electronics, the line between research and nonresearch products and services is more difficult to discern and to delineate. We support a rulemaking by the SEC to clarify the definition of research to preclude the use of soft dollars for nonresearch products and services while retaining enough flexibility so as not to preclude the development of innovative and valuable research services.

1998 SEC Report on Soft-Dollar Practices

The best starting point for evaluating actual practices related to soft dollars is the report issued by the SEC's Office of Compliance Inspections and Examinations (OCIE) in 1998.[16] From November 1996 through April 1997, OCIE conducted an extensive inspection sweep to gather information about the current uses of soft dollars, based on on-site examinations of 75 broker-dealers and 280 investment advisers and investment companies. In September 1998, OCIE issued a written report detailing the results of their sweep and setting forth recommendations for consideration by the SEC. Among the key findings set forth in the report are the following:

- "Almost all" investment advisers obtain products and services (both proprietary and third-party) other than pure execution from broker-dealers and use client commissions to pay for those products and services.
- Most products and services obtained by investment advisers with soft dollars fall within the definition of research, that is, they provide lawful and appropriate assistance to the adviser in the performance of its investment decisionmaking responsibilities.
- While most of the products acquired with soft dollars are research, OCIE found that a significant number of broker-dealers (35 percent) and investment advisers (28 percent) provided and received nonresearch products and services in soft-dollar arrangements. In such cases, OCIE found that investment advisers failed to provide meaningful disclosure to their clients.

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[14] *Supra*, fn.10.

[15] *In re Kingsley, Jennison, McNulty & Morse, Inc.,* Advisers Act Release No. 1396 (December 23, 1993); *In re Goodrich Securities Inc.,* Exchange Act Release No. 28141 (June 25, 1990); *In re Patterson Corp.,* Advisers Act Release No. 1235 (June 25, 1990).

[16] *Supra,* fn.4.

- OCIE also reported shortcomings by investment advisers with respect to "mixed use" items, for example, products that have both research and nonresearch uses.[17]

The staff report set forth the following recommendations for the SEC to consider:

"1. We noted many examples of advisers claiming the protection of the safe harbor without meeting its requirements. We also found that industry participants were not uniformly following prior Commission guidance with respect to soft dollars. As a result, we recommend that the Commission publish this report to reiterate guidance with respect to the scope of the safe harbor and to emphasize the obligations of broker-dealers, investment advisers and investment companies that participate in soft-dollar arrangements. We also recommend that the Commission reiterate and provide further guidance with respect to the scope of the safe harbor, particularly concerning (a) the uses of electronically provided research and the various items used to send, receive, and process research electronically, and (b) the uses of items that may facilitate trade execution.

"2. Many broker-dealers and advisers did not keep adequate records documenting their soft-dollar activities. We believe the lack of adequate recordkeeping contributed to incomplete disclosure, using soft dollars for nonresearch purposes without disclosure, and inadequate mixed-use analysis. We recommend that the Commission adopt recordkeeping requirements that would provide greater accountability for soft-dollar transactions and allocations. Better recordkeeping would enable advisers to more easily assure compliance and Commission examiners to more readily ascertain the existence and nature of soft-dollar arrangements when conducting inspections.

"3. We noted many instances where advisers' soft-dollar disclosures were inadequate or wholly lacking—especially with respect to nonresearch items. We recommend that the Commission modify Form ADV to require more meaningful disclosure by advisers and more detailed disclosure about the products received that are not used in the investment decisionmaking process. In addition, the Commission should require advisers to provide more detailed information to clients upon request.

"4. In light of the weak controls and compliance failures that we found, we recommend that the Commission publish this report in order to encourage advisers and broker-dealers to strengthen their internal control procedures regarding soft-dollar activities. We suggest that advisers and broker-dealers review and consider the controls described in this report, many of which were observed as effective during examinations." [18]

At the time it was issued, the OCIE report clearly represented the best available information on soft-dollar practices. In light of the fact that the report was published more than 5 years ago, one of the key questions today is whether any of the practices described in the report have changed. Some of the key issues that may warrant reexamination include whether documentation, disclosure, and control procedures relating to soft-dollar arrangements have improved.

Current SEC Initiatives

Following the recommendations set forth in the 1998 OCIE Report, the SEC issued an extensive proposal in April 2000 to revise the so-called "brochure" (Form ADV, Part 2), the disclosure document that all investment advisers must offer to provide to clients and prospective clients each year.[19] As discussed above, the proposed rule would amend the brochure requirements to mandate more specific disclosure regarding soft-dollar practices and any resulting conflicts. The ICAA expects the SEC to finalize this important rule later this year.

In addition, the SEC recently finalized a major new rule that requires all investment advisers to adopt written compliance policies and procedures that are reasonably designed to prevent violations of the Investment Advisers Act of 1940, to review such policies and procedures at least annually, and to designate a chief compliance officer who is responsible for administering the policies and procedures.[20] The written release accompanying the SEC's new regulation lists a number of areas that investment advisers should consider in developing written policies and procedures, including best execution and soft-dollar practices. Clearly, the new rule will encourage investment advisers to enhance—and review on a continuing basis—their written policies and procedures relating to soft-dollar practices and will provide the SEC with an additional tool in identifying potential problems in this area.

[17] *Id.,* at p. 3.

[18] *Id.,* at pp. 4–5.

[19] *Supra,* fn.11.

[20] *Compliance Programs of Investment Companies and Investment Advisers,* Advisers Act Release No. 2204 (December 17, 2003).

Early this year, Chairman Donaldson announced that he has directed SEC staff to explore various issues relating to soft dollars. SEC staff have been meeting with a number of interested parties to discuss issues related to soft-dollar practices, including contracts for soft-dollar arrangements, recordkeeping practices, and disclosure practices. At the March 10 hearing before this Committee, the Director of the SEC's Division of Investment Management noted in his prepared testimony that:

> Chairman Donaldson has made the issue of soft dollars a priority and has directed the staff to explore the problems and conflicts inherent in soft-dollar arrangements and the scope of the safe harbor contained in Section 28(e) of the Securities Exchange Act. The Divisions of Market Regulation and Investment Management, along with the Office of Compliance Inspections and Examinations, are working together to conduct this review. A primary area of focus is whether the current definition of qualifying "research" under the safe harbor is too broad and should be narrowed by rulemaking. The Commission has also sought public comment on whether it would be possible to require mutual fund managers to identify the portion of commission costs that purchase research services from brokers so as to enhance the transparency of these arrangements.[21]

We understand that as part of this review, the SEC is considering certain public comments that have been filed with the SEC that set forth a number of suggestions for improving disclosure of soft-dollar arrangements and for narrowing the scope of allowable research.[22] Among these comments is a suggestion that proprietary research costs be "unbundled" from execution costs.[23] Although we have not had an opportunity to fully consider this proposal, we strongly believe that any such reform should place full responsibility to calculate the cost or price of nonexecution services on the broker-dealer providing the services, rather than requiring investment advisers to make a subjective estimate regarding such services.

The ICAA fully supports the SEC's current initiative to examine soft-dollar practices and issues. Specifically, the ICAA would support an SEC rulemaking aimed at improving disclosure of soft-dollar practices and arrangements to investors and to clarify the current definition of "research."

Conclusions and Summary

In summary, the ICAA supports a rulemaking by the SEC that would:

- Enhance soft-dollar disclosure requirements, as envisioned by the SEC's proposal to revise Form ADV;
- Strengthen books and records requirements related to soft dollars; and
- Clarify the scope of allowable "research" within the Section 28(e) safe harbor.

We believe that these rule changes, combined with appropriate inspection and enforcement of these regulations will strengthen the transparency of soft-dollar arrangements and deter abuses in this area.

However, we believe that the SEC should reject suggestions to eliminate the use of soft dollars for third-party research.[24] As described in the ICAA's March 3, 2004 statement, we believe such a suggestion is fundamentally flawed:

> It would result in a diminution of quality research and thus is contrary to our strong support for independent research that benefits investors. If adopted, the proposal would unfairly advantage full-service brokerage firms and disadvantage third-party research providers, as well as clients of investment advisers who benefit from third-party research.

Finally, the ICAA believes that an SEC rulemaking is a better approach than repealing Section 28(e). While the consequences of eliminating soft dollars cannot be predicted with certainty, we believe the SEC is in the best position to consider the complex issues related to this important question. Abolishing soft dollars may well diminish the amount of quality research that is made available to investment advisers and thus may hurt investors. In addition, repealing section 28(e) may disproportionately disadvantage thousands of smaller investment advisory firms and their

[21] *Testimony Concerning the Securities and Exchange Commission's Recent Regulatory Actions to Protect Mutual Fund Investors,* Paul F. Roye, Director, SEC's Division of Investment Management, before the U.S. Senate Committee on Banking, Housing, and Urban Affairs (March 10, 2004).

[22] *See March 2, 2004 Comment Letter from Fidelity Management and Research Company to SEC re: Concept Release on Measures to Improve Disclosure of Mutual Fund Transaction Costs, Release No. 33–8349; 34–48952: IC–26313; File No. S7–29–03.*

[23] *Id.*

[24] *See December 2, 2003 Comment Letter from the Investment Company Institute to the SEC re: soft dollars.*

clients while favoring the relatively few larger firms that have greater resources to produce and acquire research.

In closing, the ICAA wishes to commend the Committee for conducting this hearing on these important issues. We would be pleased to provide any additional information that may be helpful to you in your continuing deliberations.

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FOR IMMEDIATE RELEASE

March 3, 2004

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ICAA STATEMENT RE: SOFT DOLLARS

(Washington, DC) The Investment Counsel Association of America today issued the following statement regarding soft dollars:

The ICAA fully supports SEC Chairman Donaldson's announced initiative to analyze issues related to soft dollars and we stand ready to assist the Commission in this important effort. Specifically, we encourage the SEC to require enhanced disclosure of soft-dollar practices to clients and to focus on whether the SEC's interpretation of allowable research requires clarification. However, the ICAA believes the SEC should reject the Investment Company Institute's proposal to eliminate all third-party research from soft-dollar practices. We believe this aspect of ICI's proposal is fundamentally flawed. It would result in a diminution of quality research and thus is contrary to our strong support for independent research that benefits investors. If adopted, the proposal would unfairly advantage full-service brokerage firms and disadvantage third-party research providers, as well as clients of investment advisers who benefit from third-party research.

The ICAA has been a consistent advocate for high ethical standards and strong and effective compliance practices. The ICAA *Standards of Practice,* first adopted in 1937, continue to emphasize that an investment adviser is a fiduciary that has the responsibility to render professional, continuous, and unbiased investment advice to its clients. As such, basic fiduciary principles prohibit an investment adviser from taking an interest that is potentially adverse to its clients without the client's informed consent and from using client assets for its own benefit. Client brokerage is an asset that should be used in the best interests of the client. Accordingly, investment advisers that choose to enter into soft-dollar arrangements must be mindful of their fiduciary obligations, including their duty to make full and complete disclosure to investors about such practices.

In 1975, the Securities and Exchange Commission acted to make the U.S. securities markets more competitive by abolishing fixed commission rates. Shortly thereafter, Congress enacted Section 28(e) of the Securities Exchange Act of 1934, the safe harbor that allows investment advisers to "pay up" for research. Section 28(e) provides that a person who exercises investment discretion with respect to an account will not be deemed to have breached a fiduciary duty solely by reason of having caused the account to pay more than the lowest available commission, if such person determines in good faith that the amount of the commission is reasonable in relation to the value of the brokerage and research services provided. Soft-dollar practices, as defined by the SEC, consist of arrangements in which products or services other than execution of securities transactions are obtained by an investment adviser by or through a broker-dealer as a result of the adviser's using the broker-dealer for execution of client securities transactions. The SEC's current definition of soft dollars makes no distinction between proprietary and third-party research and services.

The Investment Company Institute, a trade association that represents the mutual fund industry, wrote to SEC Chairman Donaldson in December proposing, among other things, that the SEC issue rules to exclude certain research products and services from the scope of Section 28(e), including computer hardware and software, publications that are available to the general public, and all third-party research services. In January, Chairman Donaldson stated that he had directed the SEC staff to explore a number of complex issues, including "the use of soft-dollar arrangements by investment managers and the scope of the safe harbor contained in Section 28(e) of the Exchange Act."

The ICAA fully supports Chairman Donaldson's initiative and stands ready to assist the Commission in analyzing current practices and identifying appropriate ways

to improve soft-dollar disclosure and to clarify current law. However, we believe the SEC should not eliminate all third-party research from the scope of the safe harbor.

As an initial matter, it is worth noting that the vast majority of investment advisory firms are small businesses that do not manage mutual funds. There are approximately 8,000 entities registered as investment advisers with the SEC. Of this total, more than 5,000 have 10 or fewer employees. More than 6,000 investment advisers report that they have no mutual fund clients. In fact, investment advisory firms have a wide variety of business models and investment styles and an extremely varied clientele, from individuals, families, and trusts, to a diverse range of institutional clients, including public and private pension plans, endowments, foundations, and pooled investment vehicles such as mutual funds and hedge funds. The ICAA's membership represents a cross-section of the broader universe of registered investment advisory firms.

Given the enormous diversity among the investment advisory profession and our membership, it should come as no surprise that there is not unanimous agreement on issues related to soft dollars. Some firms have expressed support for the concept of severely restricting—or even eliminating—soft-dollar usage. In fact, some firms have voluntarily taken the position that they will not engage in soft-dollar transactions, other than receiving research from full-service brokers. On the other hand, many firms have expressed a variety of serious concerns about the ICI's proposal. They particularly object to the proposal to eliminate the use of soft dollars for all third-party research, on the grounds that this will hurt clients and all investors because it will result in less innovative and independent research. Even among the minority of firms that view soft dollars as objectionable, most agree that the proposal to eliminate soft dollars for third-party research may have significant and unpredictable consequences.

We are persuaded that any proposal to eliminate soft dollars for third-party research, if adopted, would have unfortunate and untenable results. If adopted, it would have a number of profoundly negative consequences. It would result in an unjustifiable, unlevel playing field for many market participants. It would provide a regulatory-driven advantage for full-service brokerage firms and disadvantage third-party research providers. As such, it would increase costs for existing investment advisers and third-party research firms and would create an additional barrier to entry for new advisory and research firms. Most important, it would have adverse consequences for clients of investment advisory firms that benefit from third-party research. Instead of helping investors by giving investment advisers access to superior, independent research, the proposal in fact would reduce the overall research available, to the detriment of investors. Such a result would be particularly ironic in view of the problems that have been uncovered during the past few years relating to conflicted research provided by various brokerage firms. Indeed, many advisers believe that third-party research provided by independent firms is of higher quality than propriety research provided by large Wall Street brokerage firms. Further, using soft-dollar credits for third-party research is undeniably more transparent than "paying up" for proprietary research from full-service brokers bundled with execution services. Third-party research is separately identified, invoiced, and quantifiable. Proprietary research is not. In this respect, the mutual fund industry's proposal would result in less transparency to market participants, regulators, clients, and investors.

In addition, we believe that eliminating third-party research will drive up costs for many investment advisory firms and may have undesirable economic consequences, particularly for smaller firms. Accordingly, the ICAA strongly urges the SEC to evaluate carefully the impact of such a proposal on investment advisers, including the thousands of smaller investment advisory firms. We also urge the SEC to study the potential impact of such a proposal on the quality and availability of research, a review that has never, to our knowledge, been undertaken. Due to the widespread use of soft dollars, we believe that any major change in their usage may have significant and unpredictable consequences—for investors, investment advisers, third-party research providers, and full-service brokerage firms. Given these potentially far-reaching implications, the SEC should take time to investigate the likely effects of any major changes in soft-dollar regulations.

Several years ago, the SEC's Office of Compliance Inspections and Examinations conducted an intensive fact-finding effort regarding current practices. OCIE's targeted examinations involved a large number of brokerage firms and investment advisers. In September 1998, OCIE issued an extensive written report detailing its findings. Among the most prominent findings were the following: (1) Nearly all investment advisers obtain products and services (both proprietary and third-party) other than pure execution from broker-dealers and use client commissions to pay for those products and services; (2) by far, most of the products and services ob-

tained by investment advisers with soft dollars fall within the definition of research, for example, they provide lawful and appropriate assistance to the adviser in the performance of its investment decisionmaking responsibilities; and (3) in cases where investment advisers received nonresearch products and services using soft-dollar arrangements, virtually all investment advisers failed to provide meaningful disclosure of such practices to their clients (a practice that already violates current laws and regulations). A sound starting point for further SEC action would be to assess whether the conclusions from the prior report are still valid.

The ICAA believes that policy makers should ensure that there is adequate disclosure about soft-dollar practices and then allow market forces to work in determining how and when such practices make sense. Investors deserve to have accurate and complete disclosure about soft-dollar practices of brokerage firms and investment advisers so they can make a competent decision as to whether such practices are consistent with their interests. Ensuring appropriate disclosure in a competitive market will allow investors—rather than regulators—to make choices about soft-dollar practices that work for them. As noted above, some investment advisory firms already have made the voluntary decision not to engage in soft-dollar transactions involving third-party research providers. We believe that allowing market-driven decisions by investors, combined with full and complete disclosure, is certainly a better solution than abolishing soft-dollar arrangements for third-party research services.

The ICAA also supports efforts by the SEC to clarify the types of products and services that constitute permissible research under current law. We recognize that research products and services are evolving, with innovative developments continuing on an ongoing basis. However, the SEC's clear guidance in this area, to the extent feasible, will have a salutary effect on both investment advisers' compliance programs, and the SEC staff's inspection of such programs.

The ICAA supports full and complete disclosure of potential conflicts of interest that confront investment advisers, including soft-dollar arrangements. We look forward to working with the Congress, the SEC, and other policymakers to ensure that investors have full and complete disclosure of soft-dollar practices and that uniform and consistent laws and regulations are in place governing these and related issues.

* * * * *

The ICAA is a not-for-profit association that represents the interests of investment adviser firms. Founded in 1937, the ICAA's membership today is comprised of more than 300 firms that are registered as investment advisers with the SEC that collectively manage in excess of $4 trillion for a wide variety of individual and institutional investors. For more information, please visit *www.icaa.org.*

PREPARED STATEMENT OF HOWARD M. SCHILIT, PHD, CPA

CHAIRMAN AND CEO

CENTER FOR FINANCIAL RESEARCH & ANALYSIS (CFRA)

MARCH 31, 2004

Thank you for the opportunity to share my views on the role of independent research, soft-dollar commissions, and their interdependence.

My name is Howard Schilit. I am author of the book *Financial Shenanigans* and founder and CEO of the Center for Financial Research & Analysis (widely known as CFRA), a forensic accounting organization serving the investment management community. Our center serves as a "watchdog" organization for investors, warning about unusual accounting practices. For example, over the last decade, we warned investors about problems at Worldcom, Enron, Parmalat, Cendant, and Sunbeam.

Independent research organizations perform a vital watchdog role that greatly benefits investors. As we all know, our founding fathers had the wisdom to devise a system of checks and balances to not allow a single branch of Government to exert undue power. In much the same way, the independent research industry provides checks over potentially biased and misleading information distributed by public companies and their sponsors at investment banking brokerage firms.

Independent research organizations typically are paid by third-party brokers that use soft-dollar commissions. A ban on soft-dollar commissions would have a devastating impact on independent research firms and, indirectly, hurt investors. I urge this Committee to search for other solutions and leave soft-dollar payments intact.

Historical Perspective

Historically, when investment managers trade stock they have had to purchase a *bundled package of services from one source*—full-service brokerage firms. All research, trading, and other brokerage services came from this one source.

Within the last generation, competition has emerged as smaller boutique brokerage firms entered the market, driving down commission rates. In order to truly compete with the full-service brokerage firms, the boutiques needed to bundle some value-added services. Since customers wanted research, the boutiques outsourced these products by partnering with value-added independent research organizations.

Investment managers loved having new trading partners and new research sources. In contrast, traditional proprietary full-service brokerage firms were not at all pleased with competition emerging on two fronts—brokerage and research. In the "old days," proprietary brokerage firms were the only game in town; they had a monopoly on trading and research. And investors paid exorbitant commissions for research of questionable value.

Fortunately for investors, the proprietary brokerage monopoly has been threatened. Today, competition is fierce for trading commissions, driving trading costs lower for investors. And fierce competition exists on the research front, as well, with over 300 entrepreneurial independent research firms pushed to produce the most value-added research at the best price. Investors never had it so good, with commission costs dropping and high quality independent research widely available.

Unfortunately for investors, however, the proprietary brokerage firms are fighting hard to regain their monopoly in trading and research. They are pushing for a ban on soft-dollar trading—the commissions typically paid to smaller brokerage firms and later directed to independent research firms. *The single act of banning soft dollars would irreparably hurt the competition from boutique brokers and independent research providers.* And proprietary brokers would again emerge with the monopoly they enjoyed for many years.

I urge this Committee and your colleagues in Congress to create laws and policies to nurture competition. Then investors win. Banning soft-dollar payments would have unintended and undesirable effects of eliminating competition for proprietary brokerage firms on both the research and trading fronts.

Recommendation No. 1: Soft dollars should be retained to provide a flexible payment option for purchasing independent research.

Make no mistake, there are serious issues that need to be addressed to ensure that brokerage commissions charged are fair and reported in a transparent fashion and investment managers always act in the best interest of the investing public.

Before offering certain much-needed reforms, please consider the following fundamental questions:

What is the appropriate currency (brokerage commissions or cash) to be used to pay for investment research? Is it inherently wrong for investment managers to use commissions as the currency to pay for research or consulting services? I would think not, since for over 200 years most investors have used trading commissions as the sole currency for such services.

If, however, you disagree and believe that a new currency should be used—that is, cash only for research—that would be agreeable to me, provided *all* research purchased by investment managers is paid for with cash. Thus, if commissions were banned as the currency to pay for third-party independent research, then I urge you to establish a *total ban on using commissions* for any research from any source. Specifically, if an investment manager purchased research from my independent research organization and must pay cash then, in all fairness, research acquired from Merrill Lynch, Goldman Sachs, or Morgan Stanley should require a cash payment, as well. I would have absolutely no objection to creating a meritocracy that allows all research providers to compete on the same playing field. Indeed, I would advocate such an approach.

Recommendation No. 2: Assuming little interest exists in a "cash-only" approach, commissions should be the currency to pay for any investment research. No distinction should be made between proprietary and third-party research.

Assuming the commission-for-research model is retained, several important problems must be addressed:

- Bundling execution costs and nonexecution trading costs;
- Failure of mutual fund companies to include the nonexecution portion of the commission in their reported expense ratio;
- Inflated brokerage commissions; and
- Inadequate disclosure of portion of brokerage commissions directed to third-parties.

Recommendation No. 3: All brokerage organizations must unbundle execution and nonexecution costs and disclose this information to investment companies. Since non-execution brokerage commissions are identical at all firms, regulations should treat them as such.

Requiring the unbundling of brokerage costs and showing the trade execution costs and the other service costs separately can easily solve many problems that this Committee is addressing. Full-service brokerage firms typically charge 5 cents per share to trade (down in recent years from 8 cents). Included is approximately 2 cents for execution and the remaining 3 cents for nonexecution costs, such as research. Brokerage firms have not been required to disclose to investors and other stakeholders how the 3 cents per share is spent, and consequently, fail to report this information. In many cases, the 3 cents supports in-house research and operations at a proprietary brokerage firm. In contrast, at a "soft-dollar" brokerage firm, the 3 cents is paid to third-party research firms. The money generally is spent for research—indeed the reason for the trade—and it clearly benefits the investor. And, if the investment manager believes the most value-added researcher works at an independent research firm, proceeds from trades should be directed to the research enterprise. That is the essence of a "soft-dollar" arrangement.

With an unbundled menu, investment managers can now shop "à la carte." That is, they can trade with a broker with best execution and the lowest pricing. And they could purchase research and other investment tools from an organization (Wall Street proprietary or independent) based on the value-added quotient of those services. The logical result would be that:

- Commission costs would be lowered with more disclosure and competition;
- Trading volume would be reduced with less pressure to trade; and
- Research quality would improve, since only the strongest research products would be purchased.

Recommendation No. 4: Non-execution costs should be included in the expense ratio the mutual fund companies disclose.

If all brokers must disclose the nonexecution costs that pertain to research, then mutual fund companies would have the necessary data to include such costs in their expense ratio. And, I would recommend that mutual funds should be required to include such nonexecution costs in the expense ratio reported to investors.

Recommendation No. 5: Regulators and accountants should audit the records of both brokerage organizations and investment managers to ascertain proper accounting and disclosure of nonexecution costs and expense ratios.

Recommendation No. 6: Severe penalties should be meted out to organizations that fail to properly account for nonexecution costs or expense ratios.

Recommendation No. 7: Whatever changes are made, there must be one consistent set of rules concerning brokerage commissions and research services.

No distinction should be made between proprietary and third-party research. Full disclosure of an investment manager's research expenses should be required regardless of the source. Excluding costs by proprietary brokers would discriminate against third-party independent research enterprises.

Concluding Thoughts

A ban on allowing soft-dollar payments for third-party research would be a big mistake. It would not directly solve the real problems and instead, would have the undesirable effect of eliminating an important resource for investors—value-added independent research.

I believe that my recommendations would have a number of desirable results that:

- Allow the emerging industry of independent research to solidify and provide the checks and balances that Wall Street needs;
- Give investment managers choices in trading and research that would result from unbundling and disclosure of brokers commission;
- Drive trading costs down and quality of research up with healthy competition; and
- Drive out unethical commission kick-back arrangements with new mandated disclosures.

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statement of

Dr. Benn Steil
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co-author of
Institutional Investors (MIT Press, 2001)

before the

Committee on Banking, Housing and Urban Affairs
United States Senate

March 31, 2004

Examining Soft-Dollar Practices

Thank you Chairman Shelby, Ranking Member Sarbanes and members of the Committee for the opportunity to present to you this morning my views on the practice of soft-dollar trading, its significance to American investors, and why it should be eliminated.

Soft dollars are a subset of an industry-wide practice known as "commission bundling." Commission bundling involves fund managers using their clients' assets to finance the outsourcing of research, computer systems, and other support services to brokers. Technically, soft dollars refer only to bundling arrangements that are part of *an explicit, prior commitment* from a fund manager to a broker to pay that broker a minimum amount in trading commissions over a given period in return for services unrelated to trading. Such services may be provided by the broker itself, or sub-contracted to a third party.

For simplicity, I will use the term "soft dollars" to refer to the wider concept of commission bundling.

The central question before us is *why* fund managers should choose to buy research, computer systems, and other support services indirectly, as a bundle, through trading commissions, rather than directly, by agreeing a price for each product with the research purveyors, computer system purveyors, etc, and writing checks to each of them. After all, that is how normal businesses pay for their consulting, computers, etc. That is how you and I pay for such services. We do not, for

example, pay for a computer by agreeing to buy $3000 worth of telephone calls from a telephone company.

The answer to this question is simple. The fund managers are trying to finance as much of their operating costs as possible *using their clients' assets*, rather than their own. And the only way that they can do this *legally*, other than through the management fee, is through trading commissions. It would, for example, be illegal for them to buy computers through bills paid to a telephone company out of the clients' assets. But it *is* legal for them to do so through brokerage commissions. This is the significance of the Section 28(e) loophole in the Securities Exchange Act, which has given rise to a vast, industry-wide kickback scheme through which fund managers use institutional brokers to transfer fundholder assets to themselves, in a manner invisible to fundholders.

The mutual funds will tell you – indeed, legally *must* tell you - that they use soft dollars to buy "research." This is true, but also very misleading. As Mark Twain observed, Mr. Chairman, "Almost all lies are *acts* and speech has no part in them."

Let me illustrate. As you will see from the attached figure number 1, mutual funds actually pay trading commissions to brokerage firms, using their clients' money, to buy such diverse items as newspapers, magazines, online services, conference registrations, accounting services, proxy services, office administration, computers, monitors, printers, modems, cables, software, network support and maintenance agreements. And in one of the ultimate ironies, fund managers even pay inflated trading commissions to brokers in return for third-party trading cost measurement services which invariably tell them that brokers cost too much.

How significant is this problem? Let me provide just a few examples for you.

- As you will see in the attached figure 2, the average institutional broker kicks back $1 in products and services to the fund manager for every $1.60 it receives in trading commissions. That is, most of the standard institutional trading commission represents payment for items that have nothing to do with trading. As you will see in figure 3, the percentage of institutional trading commissions allocated specifically to pay for "research," rather than good trade executions, actually rose from 29% in 2001 to 39% in 2003.
- Figure 4 will show you that the average fund manager cannot possibly be seeking "best execution" for the client, as the trading desks, according to the funds themselves, only control between 21 and 29% of the commission payments. The bulk of these payments are determined in advance by others who never actually initiate trades themselves.
- How much does this practice of soft-dollar trading actually cost investors? In my attached paper on "The Economics of Soft Dollar Trading," I estimate that the true, *effective* management fee that a fundholder pays is about 70 basis points higher than the headline fee which the fundholder sees in the prospectus. This 70 basis point premium is accounted for by bad trading: commissions which are about 2.5 times higher than they would be if the fund manager were seeking best execution, even after stripping out the value of the kickback services, and implicit (or "market impact") costs about 3 times higher.

If the Committee accepts that soft-dollar trading is indeed a problem, how then should this problem be addressed? There are 3 basic approaches:

- One approach is to require increased "disclosure" of trading costs to fundholders. More information is always preferable to less, but this is not, in my view, sufficient. Since the

largest component of trading costs, so-called implicit costs, is not actually captured in visible commission fees, we must ultimately look for a solution that encourages fund managers to trade as efficiently as possible *in their own self-interest*. More fundamentally, if the practice does truly represent an abuse of fundholder assets, surely the remedy must be more robust. After all, we do not merely "regulate" fiduciary abuses by obliging fiduciaries to publish a costed inventory of client property improperly used.

- A second approach is to eliminate the 28(e) loophole entirely. In other words, fund managers would only be allowed to use trading commissions to pay for trading. This would be a big step forward, although I suspect that funds will try to continue to pay inflated commissions in return for kickback services that will simply be less visible to regulators.
- A third approach would be to oblige fund managers to pay trading commissions out of their own assets – as recommended in the March 2001 Myners Report, prepared for the UK Treasury. This would dramatically re-align fund managers' interests with those of their clients. They would immediately unbundle commissions and seek best execution *because it would be in their self-interest*, as well as the interest of their clients. It would, in fact, lead to a dramatic improvement in US market structure, with an expansion of low-cost, direct electronic trading at the expense of brokers whose only value-added is in facilitating the soft-dollar kickback system. As I show in my paper on "The Economics of Soft Dollar Trading," a typical fund management firm could cover the cost of bearing trading commissions by raising its management fee by about 18 basis points, *and this would still leave the fundholder better off by about 50 basis points*. The only losers in this unbundling process over the long run are brokers who earn their living facilitating soft-dollar kickbacks. American investors would be far better off if these brokers found another way to employ their capital.

I thank you again for the opportunity to testify this morning, and I look forward to assisting your deliberations in any way possible.

Figure 1

What Do Soft Dollars Buy?

Research

General Company	13.5%
General Economic	7.7%
Industry/Sector	6.5%
Equity	6.4%
Pricing used for research	5.5%
On line news services	4.6%
Magazines/Journals	4.4%
Fixed-Income	4.2%
International	3.5%
Fundamental Analysis	3.4%
Technical Analysis	3.2%
Newspapers	2.5%
Performance Measurement	2.2%
Mutual Fund Data	1.8%
Portfolio Accounting/Management	1.4%
CPUs	1.3%
Modem phone lines	1.0%
Seminars/Conferences	1.0%
Consulting (General)	0.9%
Newsletters	0.8%
Asset Allocation	0.6%
Other Software	0.4%
Cables	0.4%
Commodities	0.4%
Daily faxes	0.3%
Real Estate	0.3%
Derivatives	0.3%
Proxy Services	0.2%
Network Support	0.2%
Upgrades (i.e.,-software, etc.)	0.2%
Maintenance Agreements	0.2%
Printers	0.1%
Market Timing	0.1%
Total Research	**79.7%**

Mixed-Use

Portfolio Accounting/Management	1.8%
Performance Measurement	0.8%
CPUs	0.7%
Pricing service used partly for research	0.6%
Trading Facilitation	0.4%
Network Support	0.4%
General Company	0.3%
Proxy Services	0.3%
Maintenance Agreements	0.3%
On-line services	0.2%
Consulting (General)	0.2%
General Economic	0.2%
Other Software	0.2%
Upgrades (i.e.,-software, etc.)	0.2%
Printers	0.2%
Mutual Fund Data (marketing uses)	0.1%
Seminars/Conferences	0.1%
Monitors	0.1%
Cables	0.1%
Total Mixed-Use	**7.9%**

Non-Research

Proxy Services	0.4%
Membership/License Fees	0.4%
Office Administration	0.3%
Compliance Information	0.2%
Pricing used solely to value portfolio for fee purposes	0.2%
Internet Access/Information	0.1%
Seminars/Conferences	0.1%
CFA Books/Review Course	0.1%
Total Non-Research	**2.2%**

Trade Assistance

Pricing Services used for execution	5.7%
Trading Facilitation	4.0%
Maintenance Agreements	0.1%
Total Trade Assistance	**10.2%**

Source: SEC (1998)

Benn Steil **March 2004**

Figure 2

Are Trading Commissions for Trading?

- 95% of US institutional brokers receive trading commissions for services wholly unrelated to trading (*ie*, “soft dollars”).
- The average US institutional broker “kicks back” $1 in products and services to the investment adviser for every $1.60 it receives in trading commissions.
- Half of all US investment advisers failed to disclose to clients the nature of non-trading services being financed through commissions charged against the clients’ assets.
- Cross-subsidization of accounts via trading commissions is the norm, whereas only 38% disclosed the practice to clients, as required.
- Over 1/3 of US institutional brokers have illegal (*ie*, not “research-related”) arrangements with investment advisers, none of which were revealed to clients.
- Almost 2/3 of soft dollar arrangements are undocumented.
- Institutions pay the soft dollar rate (6¢ per share in 1998) whether or not they receive soft credits.

Source: SEC (1998)

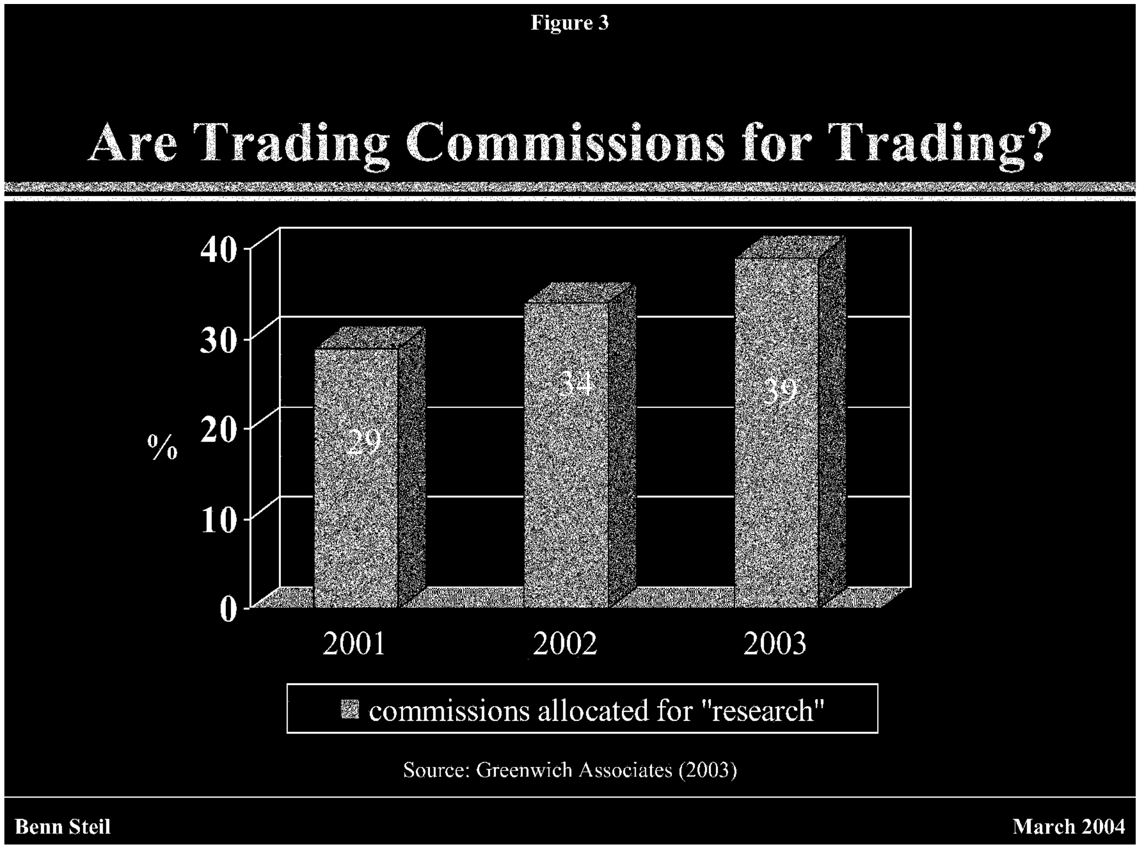
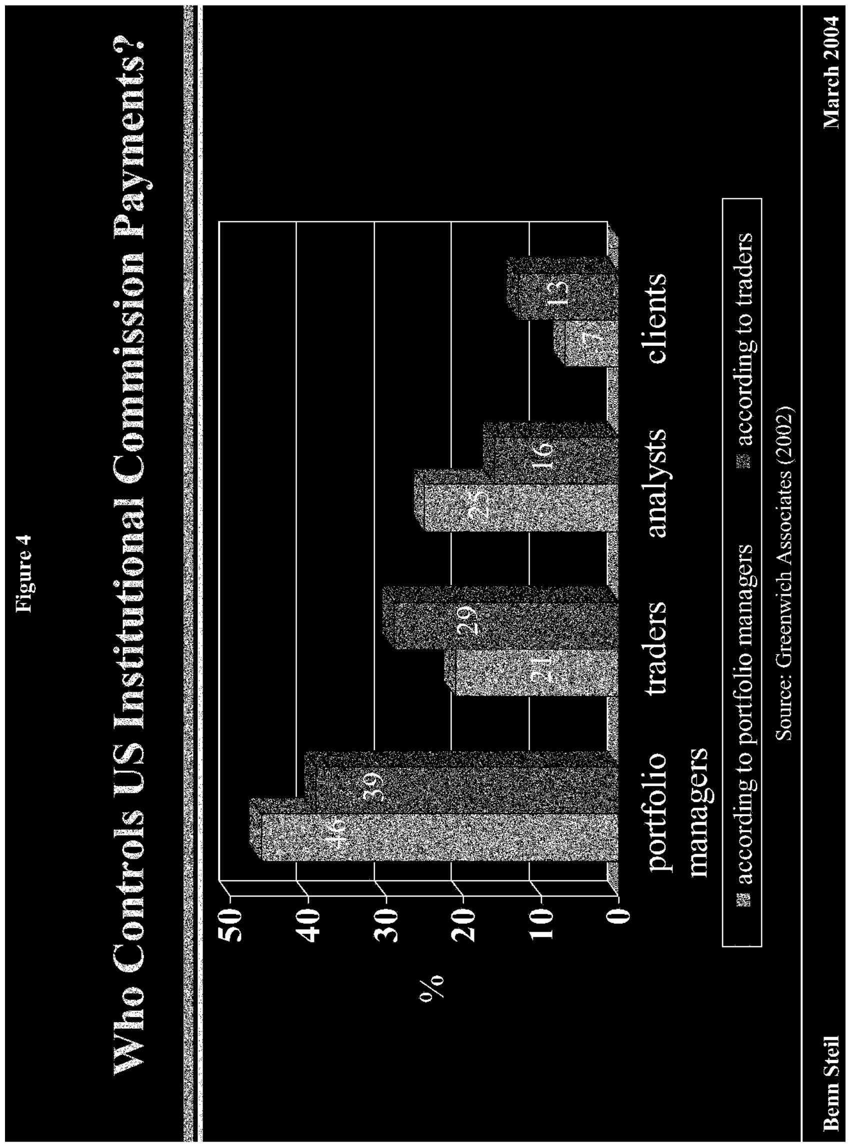


Figure 3
Are Trading Commissions for Trading?
40
30
20
10
0
%
29
34
39
2001
2002
2003
commissions allocated for "research"
Source: Greenwich Associates (2003)
Benn Steil
March 2004

Figure 4


Who Controls US Institutional Commission Payments?
%
50
40
30
20
10
0
46
39
21
29
25
16
7
13
portfolio managers
traders
analysts
clients
according to portfolio managers
according to traders
Source: Greenwich Associates (2002)
Benn Steil
March 2004

Appendix

The Economics of Soft Dollar Trading

November 2003

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The Economics of Soft Dollar Trading

So much has been written and said about the practice of "soft dollar" trading, but so little is understood about what it actually means for fundholders and fund managers.

This quantitative example is intended to clarify how a soft-dollar world, in which fund management firms purchase research and third-party analytics using fundholder assets channeled to brokers through trading commissions, differs from a hard-dollar world, in which the firms finance such purchases themselves. Using real-world brokerage pricing and trading-cost data, we estimate that the effective management fee of a typical mutual fund using soft-dollar services is approximately 70 basis points higher than the headline fee which the fundholder sees in the prospectus.

We reach the surprising conclusion that both fundholders *and* fund managers can ultimately benefit from the unbundling of trading commissions – that is, from fund managers paying for non-trade execution services with hard dollars. The clear losers from unbundling would be the traditional full-service institutional brokers.

We begin by comparing the cost of soft-dollar trading with hard-dollar trading. Figure 1 shows that after stripping out the non-trade execution service component of the standard institutional commission, explicit costs (commissions) and implicit costs (market impact) on soft-dollar trades are 2.5-3.0 times those on electronic, non-intermediated, execution-only trades.

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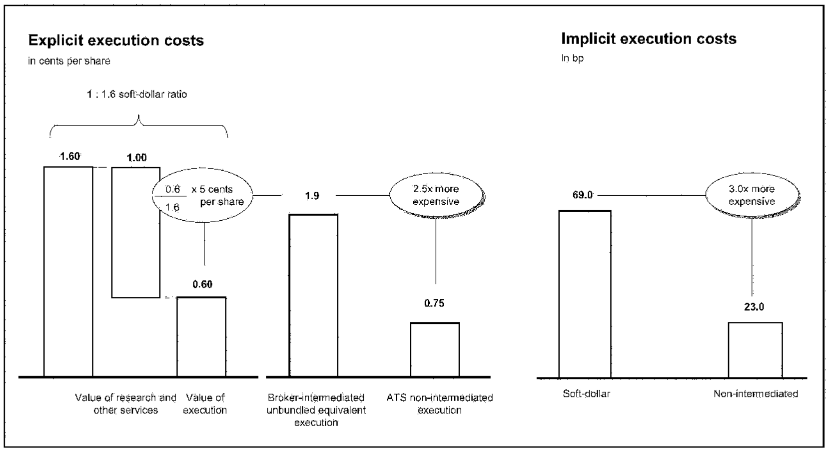
Figure 1: The Cost of Soft Dollar Trading



Data Sources: Conrad et al (2001); interviews with fund managers

The explicit cost differential is measured as follows. We take the standard full-service institutional commission rate of 5¢ per share and strip out the portion which is typically devoted to non-execution services: $1 out of every $1.60 paid in commissions. This leaves 1.9 cents per share that is paid specifically for execution. This figure is 2.5 times the 0.75¢ per share commission rate which is widely available to institutions trading over execution-only electronic brokerage services. We will refer to these below as ATSs (alternative trading systems) for simplicity.

The implicit cost differential is estimated by Conrad *et al* (2001) using trading data from Plexus' proprietary database of institutional trades. They calculate that implicit costs on soft-dollar trades are 3 times higher than those on hard-dollar trades.

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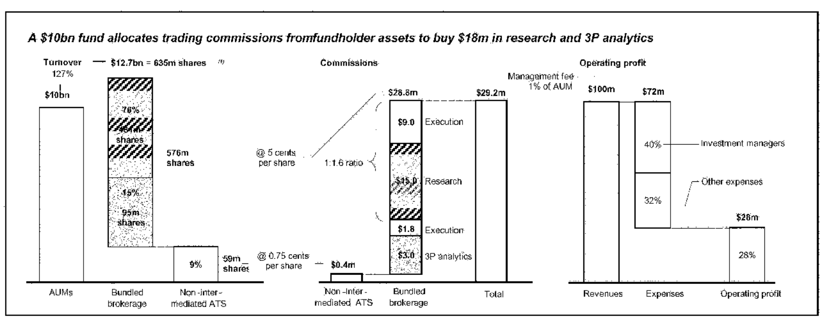
We can now consider how fund-manager profitability is affected by moving from a soft-dollar world to a hard-dollar world.

We assume a typical large fund manager operating a $10bn fund needing to purchase $15m in research and $3m in third-party analytics. Bundled commission rates are again presumed to be at the current industry standard of 5¢ per share, and non-bundled ATS rates at 0.75¢ per share.

The fund manager charges fundholders a management fee of 1% of assets under management (AUM). In a soft-dollar world, shown in Figure 2, this fund manager must direct 76% of its commissions to traditional brokers to pay for its research and 15% to soft-dollar brokers to pay for third-party analytics, leaving the remainder, 9%, which can be channeled to low-cost non-intermediated ATSs. This fund manager earns an operating profit of 28%.

Figure 2: Fund Manager Profitability in a Soft-Dollar World



Data Source: interviews with fund managers

(1) In September 2002, the NYSE and Nasdaq average share prices were $25.77 and $13.88, respectively, resulting in a weighted-average share price of $20.00. Data source: Nasdaq web site.

Let us now consider a hard-dollar world, in which the fund management firm is obliged to bear the cost of research and analytics from its own assets. This firm directs all its order flow through ATSs in order to minimize trading costs, as there is no longer any economic incentive for the firm to pay the higher bundled brokerage charges. Assuming no change in its management fee, the fund manager's operating profit falls to 10%, as shown in Figure 3.

Figure 3: Fund Manager Profitability in a Hard-Dollar World

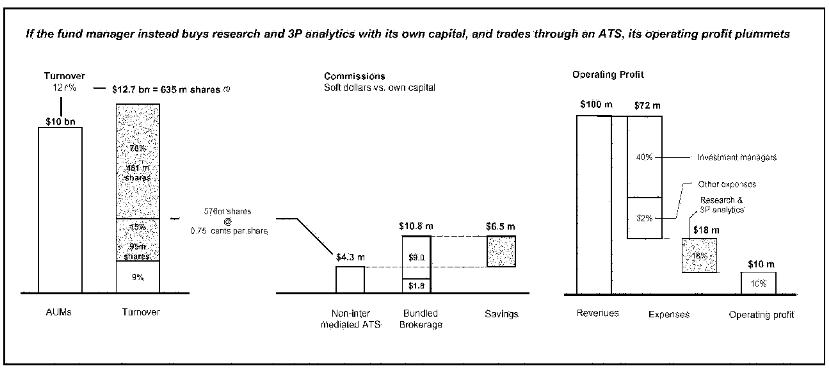
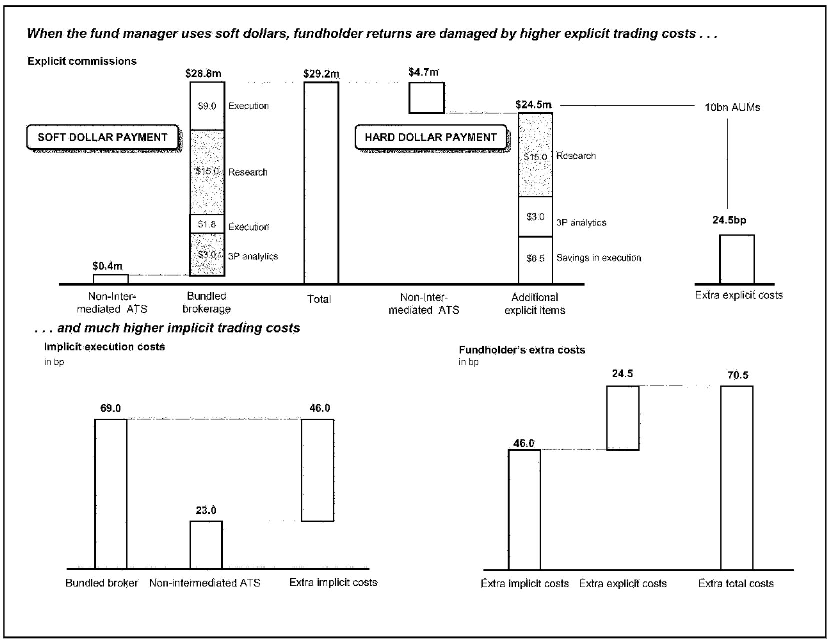


Figure 4 shows the effect on fundholders. When the fund manager uses soft dollars, the fundholder is made worse off by about 70 basis points (bp). This is comprised of 24.5bp excess explicit trading costs and 46bp excess implicit trading costs.

Figure 4: Impact of Soft Dollars on Fundholders



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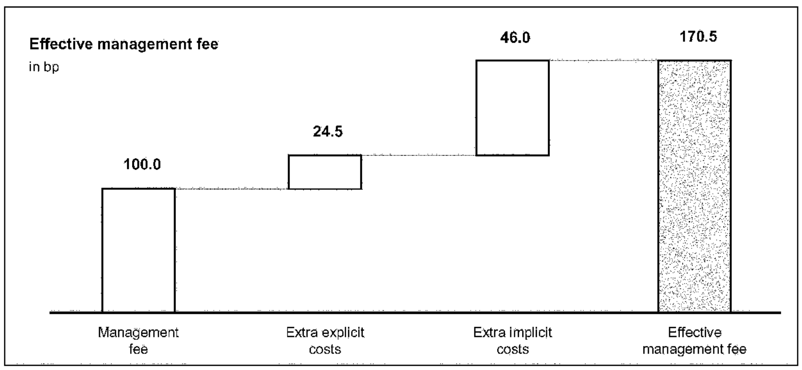
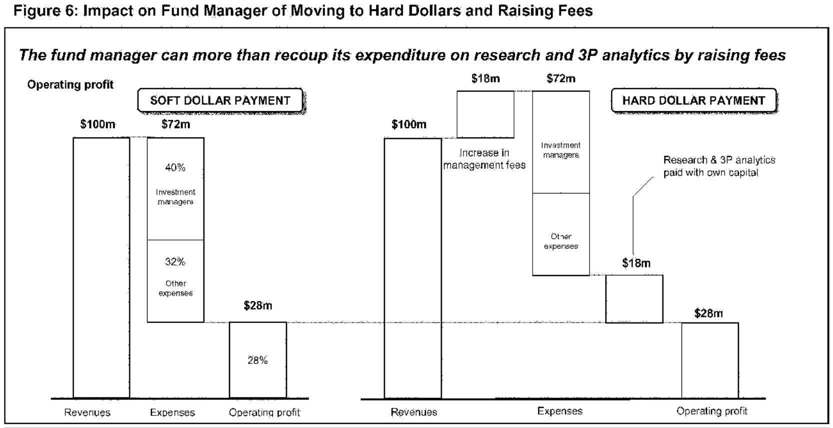
As figure 5 shows, the 1% management fee is effectively a 1.7% fee, after the effect of soft-dollar trading on the fundholder's assets is factored in.

Figure 5: Effective Management Fee



As Figure 6 shows, if the fund management firm wishes to restore its soft-dollar world operating profit of $28m, it must raise its management fee by 18%, to 1.18%. The fund manager is therefore indifferent between a soft-dollar world with a 1% management fee and a hard-dollar world with a 1.18% management fee, assuming no effect on assets under management.

Figure 6: Impact on Fund Manager of Moving to Hard Dollars and Raising Fees



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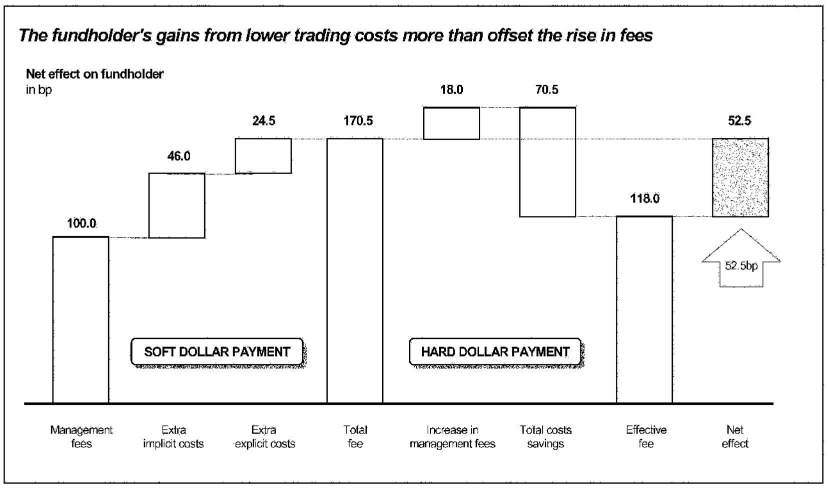
As Figure 7 shows, since the fundholder is still better off by a substantial 52bp in a hard-dollar world with a 1.18% management fee than he or she would be in a soft-dollar world with a 1% fee, there is actually tremendous scope for both the fundholder *and* the fund manager to benefit from an elimination of soft-dollar trading practices.

Figure 7: Net Impact on Fundholder of Moving to Hard Dollars



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Although many buy-side traders have long been proponents of eliminating soft dollars, upper management at their firms have been concerned that clients will react negatively to any rise in management fees necessary to offset the impact on the firms' bottom line. Thus client awareness of the significant hidden cost of soft-dollar trading will have to grow before market pressure brings an end to the practice. Regulatory reform in the US and UK, however, are likely to limit its scope. The only losers in this process will be the full-service institutional brokers, who in an age of automated trading provide no net added value beyond facilitating soft-dollar business.

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PREPARED STATEMENT OF GRADY G. THOMAS, JR.

PRESIDENT, THE INTERSTATE GROUP
DIVISION OF MORGAN KEEGAN & COMPANY, INC.

MARCH 31, 2004

Introduction and Background

Thank you for the opportunity to appear before this distinguished Committee to discuss research-commission arrangements under Section 28(e) of the Securities Exchange Act of 1934. My name is Grady Thomas. I have been in the securities business for 40 years, and in 1986 became the President of the Interstate Group, today a Division of Morgan Keegan & Co., Inc., a subsidiary of Regions Financial Corporation. I have been active in the securities industry throughout my career. I was on the Board of Directors of the Boston Stock Exchange for 8 years; served as Chairman and President of the National Organization of Investment Professionals; was a District Chairman of the NASD; two-term Governor of STA; Founding President and Chairman Emeritus of the North Carolina Security Traders Association; and am currently Chairman of the SIA Institutional Brokerage Committee.

I have been involved in providing independent research to investment managers, including mutual fund portfolio managers, for 30 years, and in that period of time I have seen innovative research flourish and commission rates fall, to the benefit of all investors. I have also seen the transparency of independent research arrangements improve to the point where investment mangers involved in independent research arrangements receive monthly statements detailing the type of research provided, its cash value, and the aggregate commissions used to pay for that research. The driving force behind these beneficial developments has been the Section 28(e) safe harbor adopted by Congress in 1975. My experience has been that Section 28(e), and various interpretations of the safe harbor by the Securities and Exchange Commission, have done an excellent job of assuring that research and execution services provided by broker-dealers to investment managers provide value to the investment managers' accounts.

You will notice that throughout my testimony I use the terms "research-commission" or "independent research" arrangement rather than "soft dollars." This is intentional. In the first place, the term soft dollars has come to have negative connotations that do not reflect the reality of independent research arrangements. Second, the term soft dollars is not defined in the securities laws, and is often used as shorthand to describe many uses of commissions by investment managers, including uses that do not involve the provision of investment research or execution services. In contrast, Section 28(e) provides protection only to arrangements where broker-dealers provide brokerage and research services that benefit an investment manager's managed accounts.

History of Research-Commission Arrangements and Section 28(e)

Because broker-dealers are deeply involved in the investment decisionmaking process through their execution and trading activities, it follows that they would also provide research and other advisory services to investors. Indeed, the practice of providing both trade execution and investment research in exchange for commissions may go back to the opening of the New York Stock Exchange in 1792. Some large full-service broker-dealers budget hundreds of millions of dollars to providing in-house research to their brokerage clients. Other firms, such as The Interstate Group, service their institutional clients by providing research services and analytical tools developed or authored by independent organizations. Arrangements for the provision of independent research are estimated to involve approximately $1 billion of institutional commissions on an annual basis. Commissions committed to proprietary research and execution-only trades are estimated at about $9 billion annually.

Definition of a Research-Commission Arrangement

A research-commission arrangement under Section 28(e) of the Securities Exchange Act of 1934 is one in which a broker-dealer provides research services to a fiduciary, such as an investment adviser or bank, who manages other people's money. In such an arrangement, the fiduciary must use the research to assist in the investment decisionmaking process on behalf of account beneficiaries. The beneficiaries pay for the research indirectly with commissions on portfolio transactions that the broker-dealer effects for their accounts.

Under a lawful Section 28(e) arrangement, a fiduciary may use commissions only to acquire services that are useful in the investment decisionmaking process. A fiduciary may not, for example, use commissions for administrative expenses such as carpeting, telephones, or other items which benefit the fiduciary but not the ac-

count. If a research service has the potential to provide administrative or nonresearch assistance to the money manager, Section 28(e) guidelines require the money manager to allocate the cost of the service according to its use. Where a research service has a "mixed-use," only that percentage of the service attributable to the investment decisionmaking process may be paid for with commission dollars. The fiduciary must use its own resources to pay for that portion of the service that provides nonresearch assistance to the fiduciary.

History of Section 28(e)

Commission rates on exchanges have been competitive only since 1975. Before that time, commission rates on portfolio transactions generally were fixed by law and had been throughout the history of the New York Stock Exchange. Under the old fixed rate system, money managers were able to obtain research through expenditure of their accounts' commissions without incurring additional costs to the accounts, since commission rates were the same regardless of whether the broker-dealer provided research. Because commission rates were fixed by law, the practice of providing research services to fiduciary accounts eventually was prevalent, as much as brokers recognized the need to compete for orders on the basis of services rendered. In this way, brokers came to provide necessary support for the professional fiduciaries' internally developed advisory functions. These business relationships and expectations that evolved between fiduciaries and their accounts continue today in the era of competitive commission rates.

When commission rates on exchanges were made competitive in 1975, the investment community was concerned that the flow of research would be restricted. Money managers feared that fiduciary principles would or could require fiduciaries to operate under the principle that "cheapest is best" and that only the lowest cost execution would avert a lawsuit for failure to obtain best execution. In response to these concerns, Congress passed Section 28(e) of the Securities Exchange Act of 1934, a safe harbor for fiduciaries who receive research services in consideration of portfolio commissions, to ensure the continued availability and quality of research in the competitive commission rate environment. The Congressional hearings on this provision reflect the notion that without Section 28(e) protection, the flow of research previously furnished to institutions under a fixed commission rate structure could be cut off, and investors would be harmed.[1]

Both Congress and the SEC have taken steps to ensure that the legal standards that apply to Section 28(e) arrangements protect the interests of investors. Section 28(e) itself limits the definition of research that can be obtained for commissions, and requires the fiduciary to determine that the commissions paid are reasonable in relation to the research and brokerage services provided. Based on the legislative history of Section 28(e), the SEC has interpreted that research services received by investment managers under these arrangements must assist the manager in the investment decisionmaking process.

Benefits to Investors of Research Commission Arrangements

Investors reap a number of benefits from the research-commission arrangements described above:

- *Flow of Research Services to Money Managers*

One of Congress' principal objectives in adopting Section 28(e) was to ensure "the future availability and quality of research and other services" to the investment community.[2] It was adopted to address the concern that investors would suffer if the flow of research services to money managers were impeded. Events over the past 29 years demonstrate that Section 28(e) has indeed facilitated the flow of research to investment managers.

Broker-dealers now provide literally hundreds of independent research services to money managers to assist in the investment decisionmaking process. The vast majority of these research services have only become available to money managers since Congress adopted Section 28(e) in 1975. These services include not only investment information but fundamental databases, portfolio modeling, and strategy software. Equally significant, the technology for the delivery, formatting, and use of information has made research more accessible to the investor and has added greatly to market efficiencies. Technology decisions relating to the investment process have become extremely important as money managers today face growing market complexities and information needs.

[1] Securities Act Amendments of 1975, Report of Committee On Banking, Housing, and Urban Affairs, S. Rep. No. 75, 94th Cong., 1st Session 71 (1975).

[2] Report of the Committee On Banking, Housing, and Urban Affairs, S. Rep. 94–75 (1975).

The Section 28(e) safe harbor has been particularly useful in assisting in the development of the independent research community. Independent research providers are often small operations using innovative and unique methodologies and targeting research at a specific segment of the market which is not given sufficient coverage by full service firms. It is extremely difficult for a small independent research provider with a limited marketing budget to gain a foothold in the market for investment research. Section 28(e) arrangements allow independent research providers to rely upon and obtain assistance from broker-dealers to gain market acceptance. In turn these broker-dealers provide independent research and execution services to many investors.

- *Competition Among Broker-Dealers Providing Research Has Reduced Execution Costs*

By becoming major competitors for institutional order flow, research brokers such as The Interstate Group have exerted downward pressure on commission rates. Since commission rates became unfixed in 1975, execution costs have declined significantly. Prior to 1975, commission rates on institutional trades were on a sliding scale based on volume with a high of $0.82 per share. In 1998, a SEC report found commission rates of about $0.06 per share for those institutional accounts examined by the SEC Staff. My experience is that commission rates today average $0.05–$0.06 per share for institutional trades.

- *Smaller Asset Managers Have Benefited from the Favorable Regulatory Environment for Providing Research in Conjunction with Execution*

In its deliberations on Section 28(e), Congress recognized that without highly developed internal research resources, smaller money management firms might be required to rely entirely on Wall Street research. Congress feared that without access to research that broker-dealers provide, small investment managers would be pressured to charge higher fees than large money managers would charge.[3]

What was true in 1975 is true today. Many startup investment advisers cannot establish their businesses and compete against larger money managers (who command large fee bases from which they can sustain in-house research) without access to the research services that broker-dealers provide. Section 28(e) has thus facilitated small firms' entry into the investment advisory business.

Common Misconceptions Regarding Section 28(e) Arrangements

Over the years, I have noted that many people within and without the financial industry harbor misconceptions regarding Section 28(e) arrangements. Following are a few I encounter most frequently.

- *Misconception 1:* Section 28(e) arrangements are used by investment managers to pay for administrative expenses such as carpeting and rent.

As discussed above, the definition of "research" under Section 28(e) extends only to items that provide assistance to fiduciaries in the investment decisionmaking process. Administrative expenses such as rent are not, and have never been, covered by the Section 28(e) safe harbor. Furthermore, in the last industry-wide examination sweep conducted by the SEC staff in 1997, the staff found no instances " . . . in which [mutual] fund commissions were used to purchase nonresearch items, which did not benefit the funds themselves." While it is true that some privately managed investment vehicles, such as hedge funds, engage in directed brokerage activity to pay for nonresearch services, this type of activity is not covered under the Section 28(e) safe harbor. Accordingly, changes to the Section 28(e) safe harbor would not effect these types of arrangements.

- *Misconception 2:* Section 28(e) arrangements lack transparency and are not disclosed to investors.

Independent or "third-party" research arrangements are among the most transparent arrangements in use in the investment industry today. Investment managers involved in such arrangements receive monthly statements detailing the dollar value of research provided, the aggregate commissions used to pay for the research and an identification of the research provided. While it is true that some proprietary research arrangements lack this level of transparency, all Section 28(e) arrangements, both proprietary and independent, must be disclosed by investment advisers in their Form ADV, and by mutual funds in their Form N–1A.[4]

- *Misconception 3:* Investment managers who execute trades with Wall Street firms, and receive proprietary research services, do not engage in "soft dollars."

[3] Report of the Committee On Banking, Housing, and Urban Affairs, S. Rep. 94–75 (1975).
[4] See Part II of Form ADV, Item 12(b); Form N–1A Item 16.

Every so often I will encounter an investment manager who will declare that his firm does not use "soft dollars." When I probe the issue, I usually discover that the manager does indeed execute portfolio trades with large Wall Street firms, and receives services such as research reports, access to research analysts, etc., from these firms. Proprietary research arrangements require the protection of the Section 28(e) safe harbor to the same extent as do independent research arrangements. However, because investment managers involved in proprietary research arrangements do not typically receive statements detailing the value and type of research they receive, they do not understand that they are indeed involved in a "soft-dollar" arrangement.

- *Misconception 4:* Requiring investment managers to pay cash for research would benefit investors.

Denying investment managers the use of portfolio commissions to purchase research would have a devastating effect on the securities markets and investors. Smaller investment managers would lack the resources to compete with larger peers, driving them out of business. Independent research firms, which have flourished in recent years, would lose the invaluable marketing mechanism provided by broker-dealers seeking to provide research to their institutional customers. Small independent research firms would fail, and the now vibrant market of new types of research would dry up.

If required to finance research expenses from their own resources, investment managers would be forced to raise management fees, or to reduce their use of investment research. Neither of these outcomes would be helpful to investors or the markets. If investor managers merely passed research costs along to investors through higher management fees, investors would end up paying more for research and commissions than they do now, as studies have shown that combining research and execution services leads to economic efficiencies that would be lost if they were provided separately. Furthermore, research costs would be less, not more, transparent than under the current structure, as they would be lumped in with all of the managers' other overhead costs.

If managers were to reduce their use of research, investors would also suffer. Studies have shown the use of research has a positive correlation with investment return. A reduction in research used by managers would result in inferior performance for investor's accounts. Many managed funds would resort to a form of indexing, trying to mimic, rather than beat, the overall market. While index-type investing certainly has a place in the investment management field, investors and the markets as a whole have greatly benefited from growth, value, and other more research-centric investment strategies in the past. The diminution of the amount of research available to managers would disproportionately affect managers who rely on these types of strategies, to the detriment of investors and the price discovery mechanism of our securities markets.

Finally, I believe this argument ignores the fact that there is nothing stopping investment management firms from determining on their own to pay for research with cash, and for competing for clients on that basis. In fact, some firms do so today. As discussed above, investment advisers and mutual funds must disclose to investors whether or not they receive research in exchange for portfolio commissions. If investors truly believe that they would benefit from using an investment manager who pays only cash for research, they can easily find such a manager. On the other hand, if managers were required to pay only cash for research, investors would lose the opportunity to select a manager or investment vehicle that benefits from the practice of combining research and execution services.

Conclusion

> Research is the foundation of the money management industry. Providing research is one important, long-standing service of the brokerage business. Soft-dollar arrangements have developed as a link between the brokerage industry's supply of research and the money management industry's demand for research.[5]

Congress' adoption of Section 28(e) in 1975 has fostered the development of innovative and useful research products by both independent and proprietary research providers. Section 28(e), and SEC interpretations thereof, have done an excellent job of assuring that research services are readily available to investment managers and provide value to investors by supporting managers in the investment decision-making process.

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[5] Statement made by the SEC Office of Compliance Inspections and Examinations in the "Inspection Report on The Soft-Dollar Practices of Broker-Dealers, Investment Advisers and Mutual Funds," (September 22, 1998, Section I.)

The last major study of Section 28(e) arrangements conducted by the SEC staff did not observe any instances in which mutual fund commissions were used to purchase nonresearch items, which did not directly benefit the funds themselves. The SEC staff did, in Section VIII of its 1998 Inspection Report, make a number of recommendations pertaining to the provision of investment research for portfolio commissions. I encourage the SEC to give further consideration to these recommendations, and note that many of them have already been adopted by The Interstate Group and other broker-dealers involved in the provision of independent research.

Thank you for the opportunity to appear before you and express my views on behalf of The Interstate Group.

PREPARED STATEMENT OF JOSEPH M. VELLI

SENIOR EXECUTIVE VICE PRESIDENT, THE BANK OF NEW YORK

MARCH 31, 2004

Introduction

Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee, I am Joseph Velli, Senior Executive Vice President of The Bank of New York. Thank you for inviting me to testify about research commissions, commonly called "soft dollars," an issue important to investors, investment managers, independent research firms and broker-dealers. We appreciate the Committee's efforts to examine issues concerning mutual fund fees, expenses, and governance. We also applaud the efforts of the Securities and Exchange Commission (SEC) in proposing rules changes designed to curb abusive behavior, address conflicts of interest and ensure that investors are given a fair shake. We think The Bank of New York can add to the dialog in a meaningful way.

The Bank of New York and BNY Securities Group

The Bank of New York is the oldest bank in the United States. It was founded in 1784 by Alexander Hamilton and was the first corporate stock to be traded on the New York Stock Exchange in 1792. Together with its parent company, The Bank of New York Company, Inc., The Bank of New York has a distinguished history of serving clients around the world through its five primary businesses: Securities Servicing and Global Payment Services, Private Client Services and Asset Management, Corporate Banking, Global Market Services, and Retail Banking. The Bank of New York Company, Inc. is a global leader in securities management services operating in more than 100 markets and servicing issuers, institutional investors, and broker-dealers. The Company plays an integral role in the infrastructure of the capital markets safekeeping over $8 trillion in investors assets. Through its nearly 23,000 employees, the Company provides quality solutions for global corporations, financial institutions, asset managers, governments, nonprofit organizations, and individuals.

I am a Senior Executive Vice President of The Bank of New York and head of BNY Securities Group. Over the past several years, The Bank of New York has greatly enhanced its brokerage and clearing capabilities through both targeted acquisitions and internal growth. This focused strategy is part of The Bank's continued efforts to provide clients with the resources and highly personalized service required to succeed in the investment marketplace. BNY Securities Group's core business lines include institutional agency brokerage, clearing and financial services outsourcing businesses.

Agency Brokerage

BNY Securities Group's execution businesses focus on agency brokerage.[1] We act as our clients' agent in the marketplace, representing their interests in seeking best execution of their orders. An agency broker receives orders from its clients—in our case, investment managers, pension plans, and corporations—and executes the transactions with the "Street," other broker-dealers in the marketplace who may be

[1] BNY Securities Group does not engage in investment banking business or principal underwriting business. One of the Group's members, Pershing Trading Company, L.P., acts as a market maker and specialist to facilitate the Group's broker-dealer clearing business. The Group's other broker-dealers, however, act solely as agent or "riskless" principal (that is, the economic equivalent of agent).

acting on their own behalf (that is, principal) or their customers (that is, agent). We earn a commission for this service, which is fully disclosed to our clients.

In contrast to an agency broker's role, a broker-dealer acting as principal buys from its customer (in the case of a sell order) or sells to its customer (in the case of a buy order) using the firm's capital. The broker-dealer makes money in such transactions by charging a mark-up or markdown, that is, adding to or subtracting from the price to the customer. In most cases, the broker-dealer's charge and the customer's cost are not disclosed to the customer.

Agency brokerage provides investors two primary benefits they do not receive when transacting with a principal: (1) transparency of the explicit cost of execution;[2] and (2) absence of a conflict between the interests of the broker and those of the client. In an agency transaction, the client receives a confirmation setting forth, among other things, the amount of commission charged by the broker.

This information enables the client to take a methodical approach in assessing execution quality: First, to review the execution quality against appropriate benchmarks (for example, volume weighted average price, market opening price, market closing price, or some other relevant measure), and second, to review whether the explicit cost of execution—the commission—was reasonable in relation to the value of the services provided.

Agency brokerage also gives clients the comfort of knowing their broker is working on their behalf. An agency broker has no incentive other than to obtain the best execution reasonably available on behalf of the client. Moreover, agency brokerage significantly reduces the risk of economic incentives that adversely affecting the client. The institutional investment community recognizes the value of agency brokerage—we believe the agency brokerage business as a percent of the total institutional brokerage business has increased significantly in the past few years.

Research Commissions and Section 28(e)

The provision of securities-related research is an integral part of the brokerage business. This is perfectly natural, for a broker's business is to assist clients in the purchase and sale of securities. Brokers are expected to know the "market," to understand and provide valuable information about securities trading activity and the factors affecting the prices of the market generally as well as individual securities. Indeed, customers demand it. As a result, brokers long have distinguished their services from competitors' by highlighting the quality of their research.

What has been true for decades is true today: Investors want their brokers to provide them with high-quality research. One need only turn on the television to see major retail financial services firms publicizing the quality of the research they provide customers to enable them to make well-informed investment decisions. Research Commissions[3] (soft dollars) are no different. Institutional brokers distinguish their services, among other ways, by providing their clients—asset managers—with research that helps the asset managers make better investment decisions on behalf of their clients (for example, mutual fund investors).

Background of Section 28(e)

It would be helpful to provide some background on the history and scope of Section 28(e) of the Securities Exchange Act of 1934. In 1975, when Congress abolished fixed commission rates, investment managers were concerned that they would be deemed to have violated their fiduciary duty to act in the best interests of their clients if they caused their clients to pay a commission higher than the lowest commission available. The concern was driven by the existing practice of an adviser obtaining from its brokers research as well as brokerage services. In some cases, the research would be directly related to transaction and the account generating the commission, while in other cases the adviser would use the research to benefit its advised accounts generally. Congress responded by enacting Section 28(e), a "safe harbor" that shields an investment adviser from breach of fiduciary duty claims for causing its clients to pay a higher commission to a broker-dealer that provides "brokerage and research services" within the meaning of the statute.

To rely on the safe harbor, an adviser must determine in good faith that the commissions paid are reasonable in relation to the value of the brokerage and research services provided. Section 28(e) permits an adviser to obtain services, particularly

[2] Implicit transaction costs, such as market impact and opportunity cost are borne by a broker-dealer's customer regardless of the mode of execution. Although such implicit costs indeed are costs to the customer, the customer's broker-dealer is not the beneficiary; such costs flow to market participants other than the executing broker-dealer.

[3] A Research Commission is one in which an investment adviser receives securities brokerage and research services from a broker-dealer in exchange for the investment adviser directing some portion of its clients' brokerage transactions to the broker-dealer.

research services, with client commission dollars so long as the adviser determines that the services provide "lawful and appropriate assistance" to the asset manager in the investment decisionmaking process.[4] Section 28(e) is a tacit recognition that securities brokers legitimately have always been in the business of providing research to their clients—the person who is making the investment decisions. In retail brokerage, the investment decisionmaker usually is the individual owner of the account. In institutional brokerage, the investment decisionmaker often is an investment adviser acting on behalf of its clients. In both cases, brokers are assisting the decisionmaker—the client—by providing research that the client deems valuable.

Scope of Section 28(e)

Many misunderstand the scope of "soft dollars" and Section 28(e). The safe harbor applies to any transaction pursuant to which an adviser causes a client to pay a higher commission than the lowest available in exchange for brokerage and research services. Specifically, it applies to commissions where the adviser receives proprietary research (proprietary research transactions) as well as commissions for third-party research services (independent research commissions). Advisers executing transactions with integrated investment banks at full service rates are engaging in soft-dollar transactions primarily with respect to the provision of proprietary research and, to a far lesser extent, with respect to the provision of third-party research. Integrated investment banks dominate the institutional commission market. In fact, independent research transactions account for only about 12 percent of the institutional commission market, $1 billion out of a total of $8.4 billion in 2003, with the vast majority of the remaining 88 percent going to investment banks.[5]

Despite the very clear application of Section 28(e) to both proprietary research commissions and independent research commissions, critics of these commissions sometimes focus on the latter. We believe the criticisms of independent research commissions are unfounded. In particular, we believe the vast majority of market participants—investment advisers, broker-dealers, and independent research providers—conduct their business in compliance with the SEC's guidance pursuant to Section 28(e).

The SEC's 1998 Sweep Report

In 1996 and 1997, the SEC's Office of Compliance Inspections and Examinations (OCIE) conducted a sweep examination of the soft-dollar industry. OCIE issued a report in 1998 detailing its findings (the Sweep Report). OCIE found that approximately 2 percent of commissions paid in purported reliance on Section 28(e) was in fact for "nonresearch products and services." OCIE's finding merits comment.

- First, OCIE's finding of only 2 percent of commissions being used for services outside the safe harbor is remarkably low, particularly considering that, prior to issuance of the Sweep Report, the legislative history, and other guidance on the definition of research for purposes of Section 28(e) was sparse. Indeed, the Sweep Report is the most extensive guidance on the topic to date.
- Second, among the items to which OCIE objected as being outside the safe harbor are proxy services, membership and licensing fees related to investment management certification programs, and services related to regulatory compliance. In most cases, the industry was acting in the good faith belief that many of these products and services were within the safe harbor.
- Third, a corollary to the first two points is that the industry's practices have improved a great deal since the Sweep Report was issued. Once guidance was issued and standards were set, even informally, the industry responded. Independent agency brokers generally, and BNY Securities Group's brokers in particular, have adopted policies and procedures designed to ensure that their practices are consistent with the requirements of Section 28(e) for those clients required or desiring to stay within the safe harbor.

The Sweep Report made a series of recommendations to the SEC regarding potential soft-dollar reforms. The primary recommendations were: (1) publication of the Sweep Report to provide guidance to investment advisers and broker-dealers; (2) enhanced recordkeeping by investment advisers and broker-dealers with respect to soft-dollar arrangements; (3) enhanced disclosure by investment advisers of research products and services; and (4) enhanced internal controls.

Advisers and agency brokers responded to the Sweep Report's guidance by adopting procedures and controls designed to ensure compliance with the requirements

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[4] See S. Rep. No. 75, 94th Cong. 1st Sess. 248 (1975); Securities Exchange Act Release No. 23170 (April 23, 1986).

[5] U.S. Equity Investors: Soft-Dollar Market Trends, Greenwich Associates, 2003.

of the safe harbor. Agency brokers, such as those within BNY Securities Group, provide detailed information to investment adviser clients regarding their brokerage commissions and the services they receive; we also retain detailed records of the products and services provided and information about the research providers. Exhibit A is a sample monthly report, which shows in great detail the commissions generated by the client and each research service, with the associated cost, provided to the client.

The Securities Industry Association has issued a Best Practices guide on soft dollars that many brokers have adopted wholesale. The Association of Investment Management and Research also issued soft-dollar standards shortly after the issuance of the Sweep Report, which have been adopted by some in the investment adviser community. In addition, the SEC recently adopted rules requiring investment advisers to adopt formal compliance programs.[6] Investment advisers are required to comply by October 5, 2004. Accordingly, we believe the current system works as intended. We believe, however, that enhanced disclosure about transaction costs would benefit investors (see below).

Independent Research Commissions Should be Encouraged

At BNY Securities Group, we believe Independent Research Commissions benefit investors and play a valuable role in the marketplace. Such commissions combine best execution and choice of independent research in an unbundled, transparent fashion. Accordingly, Congress and the SEC should encourage their use.

Best Execution

Research commissions can only exist in an environment where investment advisers are required to obtain, and broker-dealers are required to provide, best execution of the underlying securities transactions. In the case of independent research arrangements, agency brokers must compete on the basis of best execution. Advisers can obtain third-party research services from any number of sources, including other broker-dealers. Therefore, execution quality has a central role in differentiating market participants.

Agency brokers involved in independent research commissions—sometimes called "soft-dollar" brokers—provide best execution by using people and technology to find liquidity in a fragmented marketplace. BNY Securities Group's broker-dealers operate business models designed to provide choice to investment advisers. BNY Securities Group allows advisers to execute through a fully integrated agency broker with direct access to the NYSE floor, through a network of over 30 third-party executing brokers pursuant to correspondent clearing arrangements, or through an electronic communications network. Investment advisers are able to choose the model best designed to obtain the best prices reasonably available for their clients, depending on such factors as the size of the transaction, the liquidity of trading in the security, and the speed at which the adviser must execute.

Independent Research Commissions Provide Transparency

Most independent research commissions are negotiated by the investment adviser and broker-dealer based on a ratio of commission dollars to value of research services provided (for example, 1.5:1). The ratio, which represents the value of execution and research services provided, is explicit. Moreover, investment advisers engaged in such commissions receive extensive information from the providing brokers regarding the commissions they generate, the products and services they receive, and the cost of those services. This information typically is provided in detailed monthly account statements. Proprietary research commissions with integrated investment banks, by contrast, are opaque. Integrated investment banks generally do not charge a separate fee for research. Rather, trade execution and research are "bundled." The investment adviser is left to its own devices to determine what it is being charged for each service and whether the amount charged is reasonable. Accordingly, independent research commission arrangements facilitate the adviser's determination, required by Section 28(e), that the cost of the brokerage and research services is reasonable in relation to the value of such services.

The Global Research Analyst Settlement

In settling the case of tainted research with 10 major investment banks earlier this year, the SEC, the New York Attorney General, and other regulators insisted that the settling firms spend $432.5 million for their client on independent research over the next 5 years. The Global Research Analyst Settlement evinces the value of independent research product versus the value of in-house research product of

[6] *See* Investment Advisers Act Release No. 2204 (December 17, 2003).

investment banks. I discuss below the value inherent in independent investment research. It is important that Congress not place an additional unfair burden on independent research that could discourage the growth of the market for independent research, a result for example at odds with the fundamental principles of the Global Research Analyst Settlement. I believe that independent, conflict-free research is an essential element in restoring investor confidence in the markets. We should encourage, not discourage, its use.

Access to Independent Research

Independent agency brokers offer access to hundreds of sources of independent research, including fundamental and technical research on individual issuers, industry and sector analyses and broad-based economic research. We believe that access to such a wide variety of ideas encourages better decisionmaking on the part of the adviser. Many of the sources of independent research are small businesses with little or no research distribution capability. Such boutiques might not survive but for the business provided by independent agency brokers. Independent agency brokers can assist advisers in sourcing independent research and, where available, achieve volume discounts. Independent research commissions provide critical access to research and remain the most viable distribution vehicle for the independent research providers.

Small Investment Advisers Benefit the Most

Small investment advisers typically have small research departments. Many do not have the resources to create an elaborate in-house research infrastructure. Small advisers benefit the most from having continued access to a wide variety of independent research. Independent research commissions allow small advisers to compete with the bigger players.

Powerful Combination for Investors

BNY Securities Group combines best execution brokerage with an opportunity for institutional customers to select from the highest performing sources of independent research in an environment where all costs are completely transparent. If the expression "soft dollars" was created on Wall Street as jargon for those services whose costs or values are undefined, then it does not exist at the Bank of New York. Indeed, we prefer to use the term "research commissions," because it more accurately describes the practice of providing clients with research that complements our execution services, and disclosing the costs of each.

BNY Securities Group, other leading agency brokers and full service firms that offer independent research have made a business out of disclosure and commission management. Our clients expect us to account for every penny of their client's commissions, and we do. Like many other brokerage firms, we give our clients detailed monthly statements—reporting all of their trading activity, the independent research providing the cost of each. A sample client statement is attached hereto as Exhibit A.

The Intrinsic Values of Independent Research

BNY Securities Group has grown to be one of the largest aggregators of independent research in the world. We see four intrinsic values in this kind of research:

First, it is free of conflicts. While we believe the global settlement and recently adopted SEC and SRO rules[7] provide a framework for reform of research on Wall Street, the possibility of conflicts arising again is as enduring as human nature.

Second, independent research must stand on its own merits—it performs well or is no longer selected. Our clients are not required to purchase one product or service as a condition to receiving another. One of the products we offer our clients is access to a proprietary rating system, which allows the client to sort and analyze research on approximately 6,000 issuers covered by over 150 research providers according to factors they select. Utilizing this rating system, our clients can measure performance of independent research and choose only those who are providing real value.

Third, independent research is serious, innovative, and often completely different from Wall Street research. Due to its independence—and because of the system of commission payments—market data providers were able to grow from ideas into a revolutionary and highly successful research services business.

Fourth, independent research serves the public interest. Independent research firms pioneered the concept of "forensic research," hunting through complex financial documents searching for mismanagement or worse. Long before the public or regulators reacted, various independent research firms uncovered the frauds of

[7] Amendments to NYSE Rule 472 and NASD Rule 2711, and SEC Regulation AC.

Enron, Worldcom, Tyco, HealthSouth, and many more. We do not need less independent research we need more.

Research Should Be Paid for with Commissions

We believe permitting fiduciaries to use client commissions to obtain independent research provides proper incentives to the asset management and brokerage communities to promote the development and distribution of products and services that benefit investors.

The first reason research should be paid for with commission dollars is that the value of research is included in the cost of the commission. Research has just as much "right" to be paid out of the proceeds of the trade, as does the cost of executing the trade. In fact, with recent increases in trading efficiencies and declines in overall commission rates, research is often the primary value received for the commission. Disclosure will better allow the investor to judge the value of the research and will make the asset manager and broker more accountable. Some assert that mutual fund managers engage in this practice for their own benefit or without knowledge of the investor or the mutual fund's board. The correct answer to these concerns is disclosure plus stricter fund governance.

There will be considerable negative consequences to banning the use of commissions to pay for research. Among the losers will be: Investors, independent research, smaller mutual funds, agency brokers, and funds reliant on sophisticated market analytics.

We believe such a radical change will severely impair a growing and important independent research industry. We have heard from prominent independent researchers who believe that the damage will be even greater, possibly even fatal. Agency brokers and independent researchers are used to competing on an uneven playing field. The integrated investment banks dominate the market for many reasons but partially because they offer a number of highly valuable services which we do not. Allowing advisors to use commissions to pay for the research from integrated firms, but not for independent research, would simply be unfair and create a complete disadvantage.

It is not in the interests of investors in a mutual fund to require a mutual fund manager to add to the expenses of the fund when commission dollars can be, and always have been, used to defray the costs of research. Some propose a requirement that any and all research be paid for in cash and that it be included in the expense line of the fund. They assert that such requirements will push down commission rates. We believe it is far more likely that the net return to the investor will go down. We believe this will strike a hard blow to independent research just as it is coming into full bloom and will lead to the full service firms further reducing the amount of research they produce. This cannot be good for investors.

Most mutual funds often have limited internal research staffs. They rely almost exclusively on independent research. Some of the larger mutual fund complexes employ hundreds of their own researchers. Yet some of the highest returns in the industry are generated by the smaller funds. Reducing choice and hurting smaller mutual funds are not good ideas.

According to a 1998 SEC report, the smallest advisory firms use over half of their commissions for independent research, while the largest advisory firms use on average, just 8.3 percent. In other words, independent research provides essential support to smaller asset management firms; abolishing independent research commissions would extend the dominance of the largest mutual fund complexes, reducing choice, and hurting smaller mutual funds are not good ideas.

Finally, but certainly not least important, is that since the costs of independent research are disclosed, they can be, and are, audited.

Comment on Unbundling

The Bank of New York believes that commissions used to pay for research should be accounted for. We do not support full unbundling of commissions by integrated investment banks. Even though we, as agency-brokers, might benefit, we believe that full unbundling would be highly disruptive to the capital markets, difficult to accomplish, and would likely lead to a drastic reduction in research.

Conclusion

Soft-dollar practices should continue to be regulated, but let us establish the problem first. The problem is that commission dollars used to acquire research are only disclosed in 10 percent of the cases—when independent or third-party research is involved.

The Bank of New York agrees with the Securities Industries Association, which supports the current safe harbor for research created by Section 8(e) and proposes that the SEC mandate reasonable additional disclosure. We are confident that the

SEC can manage this responsibility well and we look forward to working with the Commission on this.

If we are to ban anything, let us ban the term “soft dollars.” Let’s call them what they are—independent research commissions—and let us encourage their greater use.

Mr. Chairman, Senator Sarbanes, Members of the Committee, thank you. I would be delighted to answer any of your questions.

Exhibit A

WRA Westminster Research
A BNY Securities Group Co.

Client Reporting

Westminster Research Associates has designed a state-of-the-art system to track and report transaction data and payment information.

* Trade data is captured on-line, daily from all of our executing brokers **(ABN AMRO Securities LLC, Banc of America Securities, Bear Stearns, Bloomberg Tradebook, Cuttone & Co., Dresdner Kleinwort Wasserstein, G-Trade HSBC James Capel, ITG/POSIT, J.P. Morgan Securities, Kelly & Christensen, Inc., Knight Securities, Liquidnet, Merrill Lynch, Mogavero, Lee & Co., Pershing, SG Cowen Securities, Thomas Weisel Partners, UBS PaineWebber and Wachovia Securities, Inc.)** Trades are credited on a trade date basis.

* Payments are processed on a daily basis and are reflected by remittance date.

The investment manager receives a ***single consolidated monthly statement*** which delineates all trading activity by broker as well as all research vendor payments. The statement includes:

* Monthly and YTD summaries of commission expectations and balances.
* Daily trade activity reports.
* Security activity reports.
* Commission activity by executing broker.
* Payment report summary.

150 East 52nd Street, 20th Floor, New York, NY 10022 T 212.457.3000 800.879.5777 F 212.457.3050 E wra@westminsterresearch.com

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Westminster Research

A BNY Securities Group Co.

Chris Smith

ABC Investment Management

560 Park Avenue, Suite 518

New York, New York 10022

Westminster Research
WRA
A BNY Securities Group Co.

Summary – December 2003 | ABC Investment Management

	Beginning Balance	Commission Credit	Commission Expectation	Ending Balance
January	35,286.64	84,329.44	38,499.99	81,116.09
February	81,116.09	43,068.75	2,830.62	121,354.22
March	121,354.22	42,884.02	2,830.62	161,407.62
April	161,407.62	2,532.71	38,499.99	125,440.34
May	125,440.34	0.00	2,830.62	122,609.72
June	122,609.72	40,599.17	2,830.62	160,378.27
July	160,378.27	2,048.80	38,499.99	123,927.08
August	123,927.08	48,713.15	2,830.62	169,809.61
September	169,809.61	21,137.93	2,830.62	188,116.92
October	188,116.92	17,852.77	2,830.62	203,139.07
November	203,139.07	36,352.49	2,830.62	236,660.94
December	236,660.94	15,477.60	38,499.99	213,638.55
Total		354,996.84	176,644.92	213,638.55

If you have any questions about your account, please call 212-457-3000

Westminster Research
A BNY Securities Group Co.

Trade Activity Report

ABC Investment Management

December, 2003

12/06/03

Broker	Account Name	B/S	Shares	Security	Price	Credit/Shr	Total Credit	Net
Banc of America Sec.	City of Cincinnati	B	10,000	GM	37.5	0.06	600	375,600.00
Banc of America Sec.	Acme Corp. Pen. Plan	B	20,000	GM	37.625	0.06	1,200.00	753,700.00
Bear Stearns	Acme Corp. Pen. Plan	B	20,000	GM	37.5	0.06	1,200.00	751,200.00
ITG/POSIT	Acme Corp. Pen. Plan	S	50,000	IBM	52.25	0.06	3,000.00	2,609,500.00
Merrill Lynch	City of Cincinnati	S	10,000	GM	37.625	0.06	600	375,650.00
UBS PaineWebber	Acme Corp. Pen. Plan	B	7,960	GM	37.625	0.06	477.6	299,972.60
					Commission Total		7,077.60	

12/12/03

Broker	Account Name	B/S	Shares	Security	Price	Credit/Shr	Total Credit	Net
Banc of America Sec.	City of Cincinnati	B	20,000	IBM	52.375	0.06	1,200.00	1,048,700.00
Banc of America Sec.	Acme Corp. Pen. Plan	B	20,000	IBM	52.375	0.06	1,200.00	1,048,700.00
Bear Stearns	City of Cincinnati	B	10,000	IBM	52.25	0.06	600	523,100.00
J.P. Morgan Sec.	City of Cincinnati	B	10,000	DIS	43.25	0.06	600	433,100.00
Merrill Lynch	Acme Corp. Pen. Plan	B	20,000	DIS	43.25	0.06	1,200.00	866,200.00
UBS PaineWebber	Acme Corp. Pen. Plan	S	10,000	GM	37.5	0.06	600	374,400.00
UBS PaineWebber	Fort Howard	S	50,000	DIS	43.25	0.06	3,000.00	2,159,500.00
					Commission Total		8,400.00	

Westminster Research
WRA
A BNY Securities Group Co.

Security Activity Report - Buys — ABC Investment Management

Monthly Summary — December, 2003

Security	Broker	Shares		Commissions
General Motors (GM)	Banc of America Securities	30,000		1,800.00
	Bear Stearns	20,000		1,200.00
	UBSPaineWebber	7,960		477.6
		57,960	**Avg. 37.5625**	**3,477.60**
International Business Machines (IBM)	Banc of America Securities	40,000		2,400.00
	Bear Stearns	10,000		600
		50,000	**Avg. 53.3333**	**3,000.00**
Walt Disney (DIS)	J.P. Morgan Securities	10,000		600
	Merrill Lynch	20,000		1,200.00
		30,000	**Avg. 43.2500**	**1,800.00**
			Total	8,277.60

WRA Westminster Research
A BNY Securities Group Co.

Security Activity Report - Sells | ABC Investment Management

Monthly Summary | December, 2003

Security	Broker	Shares		Commissions
General Motors (GM)	Merrill Lynch	10,000		600
	UBS PaineWebber	10,000		600
		20,000	**Avg. 37.5625**	**1,200.00**
International Business Machines (IBM)	ITG/POSIT	50,000		3,000.00
		50,000	**avg. 52.2500**	**3,000.00**
Walt Disney (DIS)	UBS PaineWebber	50,000		3,000.00
		50,000	**avg. 43.2500**	**3,000.00**
			Total	7,200.00

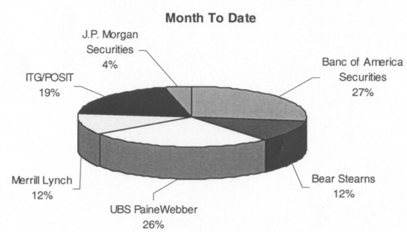
Westminster Research
WRA
A BNY Securities Group Co.

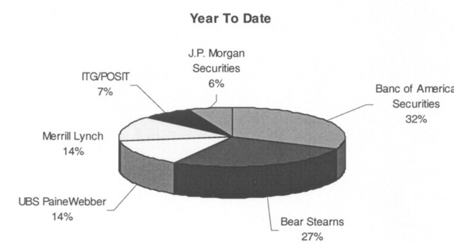
Commission Activity by Broker

ABC Investment Management

December, 2003

Broker	Month To Date	Year To Date
Banc of America Securities	4,200.00	111,532.25
Bear Stearns	1,800.00	96,460.33
UBS PaineWebber	4,077.60	51,244.55
Merrill Lynch	1,800.00	48,601.69
ITG/ POSIT	3,000.00	24,236.82
J.P. Morgan Securities	600	22,921.20
Total	15,477.60	354,996.84





Westminster Research
A BNY Securities Group Co.

Sub-Account Activity by Broker

ABC Investment Management

December, 2003

Broker	Sub-Account Name	Account Number	Commission	Total
Banc of America Sec.	City of Cincinnati	032-11562-0-1-006	1,800.00	
	Acme Corp. Pen. Plan	055-99988-9-2-600	2,400.00	4,200.00
Bear Stearns	Acme Corp. Pen. Plan	067-00099-9-3-001	1,200.00	
	City of Cincinnati	067-00100-9-9-001	600	1,800.00
ITG/POSIT	Acme Corp. Pen. Plan	000-998147-109	3,000.00	3,000.00
J.P. Morgan Securities	City of Cincinnati	746-00006-9-8	600	600
Merrill Lynch	City of Cincinnati	34N-99977-9-9-34N	600	
	Acme Corp. Pen. Plan	34N-10099-9-5-34N	1,200.00	1,800.00
UBS PaineWebber	Acme Corp. Pen. Plan	M5-00055-9-1-AA	1,077.60	
	Fort Howard	M5-00099-9-3-CC	3,000.00	4,077.60
			Grand Total	15,477.60

WRA Westminster Research
A BNY Securities Group Co.

Sub-Account Activity by Sub-Account

ABC Investment Management

December, 2003

Sub-Account Name	Broker	Account Number	Commission	Total
Acme Corp. Pen. Plan	Banc of America Securities	055-99988-9-2-600	2,400.00	
	Bear Stearns	067-00099-9-3-001	1,200.00	
	ITG/POSIT	000-998147-109	3,000.00	
	Merrill Lynch	34N-10099-9-5-34N	1,200.00	
	UBS PaineWebber	M5-00055-9-1-AA	1,077.60	8,877.60
City of Cincinnati	Banc of America Securities	032-11562-0-1-006	1,800.00	
	Bear Stearns	067-00100-9-9-001	600	
	J.P. Morgan Securities	746-00006-9-8	600	
	Merrill Lynch	34N-99977-9-9-34N	600	3,600.00
Fort Howard	UBS PaineWebber	M5-00099-9-3-CC	3,000.00	3,000.00
			Grand Total	15,477.60

WRA Westminster Research
A BNY Securities Group Co.

Vendor Payment Report

ABC Investment Management

December, 2003

Service	Invoice Date	Remitted	Invoice #	Check #	Amount	Monthly Total
Media Group Research	12/03/2001	12/04/2001	120122500	103004	5,000.00	5,000.00
ILX Systems	12/03/2001	12/06/2001	87921	103027	1,555.00	1,555.00
American Stock Exchange	11/01/2001	12/10/2001	C12345A	103052	62.5	62.5
Jarrett Investment Research	12/14/2001	12/14/2001	497	103132	2,500.00	2,500.00
Global Investment Research	12/21/2001	12/26/2001	X00123	103174	4,382.50	4,382.50
					Total	13,500.00

Westminster Research
A BNY Securities Group Co.

Vendor Summary

ABC Investment Management

Hard Dollar Payments/Commission Expectation

December, 2003

Vendor		January	February	March	April	May	June	July	August	September	October	November	December	Totals
*13D Research	(hard)	—	0	0	—	0	0	—	0	0	0	0	—	—
	(soft)	14,875.00	0	0	14,875.00	0	0	14,875.00	0	0	0	0	14,875.00	59,500.00
American Stock Exchange		62.5	62.5	62.5	62.5	62.5	62.5	62.5	62.5	62.5	62.5	62.5	62.5	750
		109.37	109.37	109.37	109.37	109.37	109.37	109.37	109.37	109.37	109.37	109.37	109.37	1,312.44
Global Investment Research		4,382.50	0	0	4,382.50	0	0	4,382.50	0	0	0	0	4,382.50	17,530.00
		7,669.37	0	0	7,669.37	0	0	7,669.37	0	0	0	0	7,669.37	30,677.48
ILX Systems		1,555.00	1,555.00	1,555.00	1,555.00	1,555.00	1,555.00	1,555.00	1,555.00	1,555.00	1,555.00	1,555.00	1,555.00	18,660.00
		2,721.25	2,721.25	2,721.25	2,721.25	2,721.25	2,721.25	2,721.25	2,721.25	2,721.25	2,721.25	2,721.25	2,721.25	32,655.00
Jarrett Investment Research		2,500.00	0	0	2,500.00	0	0	2,500.00	0	0	0	0	2,500.00	10,000.00
		4,375.00	0	0	4,375.00	0	0	4,375.00	0	0	0	0	4,375.00	17,500.00
Media Group Research		5,000.00	0	0	5,000.00	0	0	5,000.00	0	0	0	0	5,000.00	20,000.00
		8,750.00	0	0	8,750.00	0	0	8,750.00	0	0	0	0	8,750.00	35,000.00
Total Commission Expectation		38,499.99	2,830.62	2,830.62	38,499.99	2,830.62	2,830.62	38,499.99	2,830.62	2,830.62	2,830.62	2,830.62	38,499.99	176,644.92

* Product quoted in commission dollars

Exhibit B

Independent Research Commissions

BNY Securities Group

Solutions from The Bank of New York

BNY Securities Group | For the Record

- We are committed to helping clients meet their objectives by providing choice and innovative solutions in a framework of best execution.
- The majority of our business is execution-only, which we continue to build and focus on, in order to add value for our clients.
- We fully support the use of Independent Research Commissions (i.e. soft dollars) and are taking an active role with regulators, legislators, and industry trade associations.
- This document is intended to provide an overview and a basic awareness of soft dollar issues.
- The real benefit of a soft dollar update can only be realized through a detailed discussion, preferably in person, with one of our soft dollar experts. We strongly encourage you to maintain an ongoing dialogue with us.
- We believe that we are closer to this issue than any other organization and can provide unique insight and value, enabling our clients to make informed decisions.

BNY Securities Group | Agenda

- Introduction to Our Organization
- History of a Commission
- Regulation of Broker Commissions in the U.K.
- Section 28(e) – The "Safe Harbor"
- Commissions Generated by Institutional Investors
- Anatomy of a Commission
- Best Execution – Best-of-Breed Research
- Value of Market Data and Analytic Services
- Potential Impact of Inequitable Regulatory Treatment
- Where We Are Today – Our Views
- Our Recommendations
- Disclosure Proposals

BNY Securities Group | Introduction to Our Organization

The Power of Choice

Whatever your business model, BNY Securities Group has a range of solutions designed to give you the tools you need to gain a competitive edge in the investment marketplace:

- Pershing
- BNY Brokerage
- B-Trade
- G-Trade
- G- Port
- Westminster Research
- BNY Jaywalk

Facts About BNY Securities Group

- Largest institutional agency brokerage, clearing and financial services outsourcing organization
- Offices in the U.S., Europe, Asia, and Australia
- 80 global markets for execution and clearing
- Largest institutional electronic broker for global execution
- Largest provider of commission management services
- 26 NYSE seats
- 400 million shares executed daily

The BNY Securities Group Difference

- **Choice:** Agency brokerage and clearing solutions through diverse business models
- **CLIENTfirst:** Culture centered on clients' needs by delivering high-quality, personalized service
- **Competency:** Experienced professionals and innovative technology
- **Conflict-free:** Independent research and no proprietary underwriting
- **Connectivity:** Relationships and routing to clients and partners
- **Cost-effective:** Efficiency and straight-through processing
- **Consistency:** Control over settlement and clearing operations
- **Competitiveness:** Provide clients with the tools, products, and services to ensure their success
- **Commitment:** Backed by the depth of resources and strength of The Bank of New York

BNY Securities Group | History of a Commission

Prior to 1975

- Commission rates were fixed
- Brokerage firms differentiated themselves by providing value-added services, including research, to their clients

1975 ("May Day")

- Congress abolished fixed commission rates
- Advisers were concerned that they would be violating their fiduciary duties if they caused their clients to pay a commission higher than the lowest available in order to continue to receive research and brokerage services

1975 Amendments - Section 28(e) enacted

- Congress responded by enacting Section 28(e) of the Securities Exchange Act of 1934
- Section 28(e) created a "safe harbor"
  - Protects advisers from claims of breach of fiduciary duty for causing clients to incur higher commission costs if the broker-dealer provides "research and brokerage services" within the statute

1986 – SEC Interpretation

- Release 23170 clarified that Section 28(e)'s definition of research includes third-party research

BNY Securities Group | Regulation of Broker Commissions in the U.K.

1986/1987

- Fixed minimum commissions abolished in London ("Big Bang")
- The Stock Exchange created clear baskets of commissions defined as bundled brokerage and soft commission arrangements

2001

- Paul Myners was commissioned by the U.K. Treasury Dept. to review investment managers' practices (resulting report entitled "Myners Report")
  - Myners Report was a wide-ranging study with one page dedicated to Transaction Cost Analysis

2003

- In response to the Myners Report, the Financial Services Authority (FSA) published Consultation Paper (CP) 176, which contemplates two measures:
  - To limit a fund manager from receiving market pricing and information services through soft commission arrangements
  - To curtail a fund manager from passing the cost of bundled research and other services to its clients

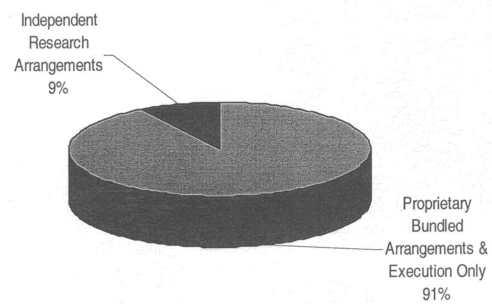
BNY Securities Group | Section 28(e) – **The "Safe Harbor"**

- To rely on the safe harbor, a fiduciary must determine, in good faith, that the commissions paid are reasonable in relation to the value of the brokerage and research services provided
- Soft Dollar arrangements under Section 28(e) are categorized in two ways:
  - Proprietary Bundled Arrangements
  - Independent Research or Third-Party Arrangements
- Full-service firms offer the following through a bundled commission rate:
  - Proprietary research
  - Access to issuer management
  - Capital commitment
  - Access to IPOs (Not "research" within the scope of Section 28(e))
  - Fund distribution and marketing (Not "research" within the scope of Section 28(e))
- Independent Research (Third-Party) Arrangements are used to acquire:
  - Non-proprietary research from third-party providers, such as Bloomberg and First Call
  - Conflict-free analysis and insight provided by independent research boutiques

BNY Securities Group | Commissions Generated by Institutional Investors

Total Gross Commissions Generated (In 2001[1])

U.S. Institutional Investors



Proprietary Bundled & Execution Only Arrangements = $8,600*

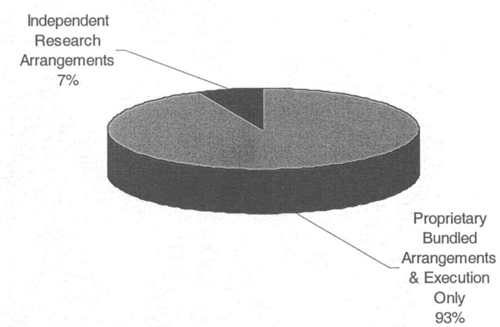
Independent Research Commissions = $800*

*In Millions

[1]Greenwich Associates Survey, 2001

Total Gross Commissions Generated (In 2000[2])

U.K. Institutional Investors



Proprietary Bundled & Execution Only Arrangements = £2,285.71**

Independent Research Commissions = £160**

**In Millions

[2]OXERA Report (April 2003), Table 3.2

BNY Securities Group | Anatomy of a Commission

Soft Dollar Commissions

Example: Buy 1,000,000 Shares XYZ Corporation

$0.05/share commission rate

Bundled Brokerage Arrangements	
Access to Management	?
Access to IPO market	?
Access to Analysts	?
Capital Commitment	?
Fund Placement Marketing & Distribution	?
Execution, Clearing, Settlement & Administration	?
Total	**$50,000**

$0.05/share commission rate

Independent Research Arrangements	
Access to Analyst (Tiburon Research)	$14,000
Quantitative Research (Sabrient Systems)	$8,000
Washington Political Analysis (Capitol Analysts Network)	$6,500
Analytic Systems (Bloomberg LP)	$4,833
Execution, Clearing, Settlement & Administration	$16,667
Total	**$50,000**

BNY Securities Group

BNY Securities Group| Best Execution – Best-of-Breed Research

- Proprietary bundled arrangements
  - Forces advisers to execute through an investment bank to gain access to their "star" analyst
  - Such arrangements create conflicts, which could compromise an adviser's duty to obtain best execution
  - Limited disclosure of proportion of research vs. execution cost
  - No breakdown of products and services received or their cost
- Ability for advisers to obtain third-party research services from multiple sources, including brokers, creates a marketplace where execution quality has a central role in differentiating market participants
- Independent Research Arrangements
  - Provide payment mechanism for independent, un-conflicted ideas and analysis
  - Assist investment advisers in better decision making
  - Provide greater transparency through a virtual unbundling of commissions, allowing for full accountability of clients' assets
  - Make research and execution costs explicit

BNY Securities Group | Value of Market Data and Analytic Services

- Market Data Providers include Reuters, Baseline, Thomson, Bloomberg & others
- Value of Market Data and Analytic Services
  - Highly sophisticated products include data feeds, quotes, news, analyses, analytics and customizable functions
  - No less "research" merely because there is an explicit price associated with them or because they are dynamic, interactive tools rather than the more traditional written research reports
- How are these tools used?
  - Many fund managers use tools to support investment and trading strategies
  - Examples: Momentum investors, Quantitative investors
- How should "research" be defined?
  - The definition will evolve along with changes in market practices, investment strategies, and technology
  - Should not be limited to a definitive "list" of services
- Who should be the ultimate decision-maker?
  - Fund managers, as part of their fiduciary responsibility, should determine what services provide "lawful and appropriate assistance" in the investment decision-making process

BNY Securities Group | Potential Impact of Inequitable Regulatory Treatment

- Threat to independent research as an emerging industry
- Disadvantages advisers who rely on independent research to formulate investment decisions
- Reduction in independent research thwarts innovation and competition and effects investment performance
- Advantages hedge fund community as compared to mutual fund organizations
- Advantages non-U.S. asset managers over U.S. asset managers who will have higher expense ratios
- Reduction in amount of available independent research leads to higher costs and lower returns for investors
- Advisors who curtail their usage of commissions to pay for independent research will be disadvantaged compared to those who do not

BNY Securities Group | Where We Are Today - Our Views

- Evidenced by Global Research Settlement, regulators have been encouraging use of independent research, which we believe will continue
- Most recent in-depth review of soft dollars, the SEC's 1998 Sweep Report, revealed few problems
- Numerous organizations are taking a strong and favorable position in support of independent research arrangements
- Usage of commissions by asset managers to support independent research continues to grow
- Proprietary bundled arrangements lack transparency as compared to independent research arrangements
- Independent research arrangements provide unbundled, conflict-free independent research in a framework of best execution
- Products from providers such as Bloomberg, Reuters and others, represent the purest form of independent research and are properly within the scope of Section 28(e)
- Independent research and proprietary research are, and should continue to be, treated equally under Section 28(e)

BNY Securities Group | Our Recommendations

Encoding Further Disclosure

- Enhanced disclosure between brokers and fund managers
  - Would enable fund managers to fulfill their fiduciary duties
  - Would arm them with information necessary to determine whether they are obtaining adequate value for their clients' commissions
- Fund managers should be supplied with reports from brokers
  - Outlining commissions earned by broker and types of research and brokerage services provided
  - Currently, this occurs for Independent Research Arrangements, but not Proprietary Bundled Arrangements

Support Soft Dollar Study

- Support SEC review of soft dollar practices as proposed in H.R. 2420 and Senate legislation on mutual fund reforms

BNY Securities Group | Disclosure Proposal 1 - Commission Type

Hypothetical example of an investment adviser's commission statement

Investment Adviser Commission Allocation Disclosure

	Total Commission Dollars Generated	% of Total Commissions
	$ 1,250,000.00	**$ 1,250,000.00**
1. Execution Only* *Includes Commission Recapture	$ 250,000.00	20%
2. Proprietary Research Commissions	$ 850,000.00	68%
3. Independent Research Commissions	$ 150,000.00	12%
	$ 1,250,000.00	**$ 1,250,000.00**

BNY Securities Group | Disclosure Proposal 2 – Commissions and Usage

Investment Adviser Commission Allocation Disclosure		Total Commission Dollars Generated		% of Total Commissions
Total:	**$**	**1,250,000**	**$**	**1,250,000.00**
1. Execution Only *	**$**	**250,000**		20%
* Includes Commission Recapture				
2. Full-Service Commissions	**$**	**850,000**		68%
Proprietary Research				
- William Smith (Technology Analyst)	$	90,000		
- John Doe (Healthcare Analyst)	$	80,000		
- **Access to Issuer Management**	$	80,000		
Capital Commitment	$	100,000		
Other Commitments				
- **Access to IPOs**	$	300,000		
- **Fund Marketing, Distribution and Placement**	$	200,000		
3. Independent Research Commissions	**$**	**150,000**		12%
Gerson Lehrman Group (Access to Experts from Industry)	$	40,000		
Tiburon Research (Retail Analysis)	$	30,000		
Sabrient Systems (Quantitative Research)	$	10,000		
Bloomberg LP (Analytic Systems)	$	50,000		
Thomson Financial - First Call (Analyst Ratings)	$	20,000		

Product detail is already provided under Independent Research Arrangements

BNY Securities Group

EXHIBIT C

Independent Research Commissions

We appreciate the opportunity to express our views concerning the recent Congressional and regulatory scrutiny focused on mutual fund fees and expenses. In this paper, we address issues regarding soft-dollar arrangements, particularly those soft-dollar arrangements whereby broker-dealers provide third-party services, which we call independent research arrangements.[1] As discussed in detail below, we believe the current system works well, although we support enhanced disclosure of quantitative information regarding investment advisers' use of client commissions and advisers' brokerage allocation practices. We also emphasize that any changes contemplated must be applied fairly.

The Bank of New York, through a number of entities in the BNY Securities Group sector, is committed to providing institutional clients, such as investment advisers, institutional investors, and broker-dealers, with a broad range of agency brokerage, clearing and financial outsourcing services. Critical components of the Group's offerings include trade execution, commission management, and independent research. Investment advisers can maximize the value of their clients' commission dollars by choosing a broker capable of providing best execution and a host of independent third-party research services unencumbered by investment banking conflicts. We believe we are uniquely qualified to comment on the current legislative and regulatory focus on soft-dollar arrangements.

Regulatory Status of Soft-Dollar Arrangements

"Soft dollars" are arrangements under which an investment adviser receives securities brokerage and research services from a broker-dealer in exchange for the investment adviser directing some portion of its clients' brokerage transactions to the broker-dealer. It has been estimated that 90 percent of investment advisers engage in soft-dollar arrangements.[2]

An investment adviser has a fiduciary duty to act in the best interests of the client. In 1975, when Congress abolished fixed commission rates, there was a concern that advisers would be deemed to have violated their fiduciary duty if they caused their clients to pay a commission higher than the lowest commission available. The concern was driven by the existing practice of an adviser obtaining research services that might not directly benefit the account generating the commissions. Congress responded by enacting Section 28(e) of the Securities Exchange Act of 1934, a "safe harbor" that shields an investment adviser from breach of fiduciary duty claims for causing its clients to pay a higher commission to a broker-dealer that provides "brokerage and research services" within the meaning of the statute. To rely on the safe harbor, an adviser must determine in good faith that the commissions paid are reasonable in relation to the value of the brokerage and research services provided. Thus, Section 28(e) permits an adviser to obtain services, particularly research services, with client commission dollars even though the services do not directly benefit any particular client.

Many misunderstand the scope of "soft dollars" and Section 28(e). The safe harbor applies to any transaction or arrangement pursuant to which an adviser causes a client to pay a higher commission than the lowest available in exchange for brokerage and research services. Specifically, it applies to arrangements where the adviser receives *proprietary research,* as well as arrangements for third-party research services. Advisers doing business with integrated investment banks (for example, Morgan Stanley or Goldman Sachs) at full service rates are engaging in soft-dollar transactions primarily with respect to the provision of proprietary research and, to a far lesser extent, with respect to the provision of third-party research. Integrated investment banks dominate the institutional commission market. In fact, independent research arrangements account for only about 10 percent of the institutional commission market, less than $800 million out of a total of $8.6 billion in 2001, with the vast majority of the remaining 90 percent going to investment banks.[3] In other words, investment banking firms dominate the soft-dollar market.

We believe that permitting an adviser to obtain execution services and independent research that the adviser determines provides lawful and appropriate as-

[1] Throughout this paper, we refer to brokerage arrangements that include provision of third-party research services as "independent research arrangements," and brokerage arrangements that include provision of proprietary research services as "soft-dollar" arrangements. We also use the term "soft dollars" to identify generally the practice whereby an investment adviser causes its clients to pay a commission higher than the lowest commission available in consideration for the value of brokerage and research services provided.

[2] Greenwich Associates Survey, 2001.

[3] Greenwich Associates Survey, 2001.

sistance in its investment decisionmaking process serves the best interests of the adviser's clients. Independent agency brokers and independent research arrangements provide the combination of best execution and independent research.

Independent Agency Brokers Provide Best Execution

Independent agency brokers—sometimes called "soft-dollar" brokers—provide best execution by using people and technology to find liquidity in a fragmented marketplace. BNY Securities Group's broker-dealers operate business models designed to provide choice to investment advisers. BNY Securities Group allows advisers to execute through a fully integrated agency broker with direct access to the NYSE floor, through a network of over 30 third-party executing brokers pursuant to correspondent clearing arrangements, or through an electronic communications network. Indeed, independent agency brokers must compete on the basis of best execution. Advisers can obtain third-party research services from any number of sources, including other broker-dealers. Therefore, execution quality has a central role in differentiating market participants. Integrated investment banks offering proprietary research, by contrast, do not necessarily have to compete on the same basis. For example, an adviser may be forced to trade through Investment Bank XYZ to gain access to XYZ's "star" analyst or to receive higher-end proprietary quantitative research or modeling products. Such arrangements create conflicts, which could compromise an adviser's duty to obtain best execution.

Independent Research Arrangements Provide Greater Transparency

Most independent research arrangements are negotiated by the investment adviser and broker-dealer based on a ratio of commission dollars to value of research services provided (for example, 1.5:1). The ratio, which represents the value of execution and research services provided, is explicit. Moreover, investment advisers engaged in such arrangements receive extensive information from the providing brokers regarding the commissions they generate, the products and services they receive, and the cost of those services. This information typically is provided in detailed monthly account statements. Proprietary research soft-dollar arrangements with integrated investment banks, by contrast, are opaque. Integrated investment banks generally do not charge a separate fee for research. Rather, trade execution and research are "bundled." The investment adviser is left to its own devices to determine what it is being charged for each service and whether the amount charged is reasonable. Accordingly, independent research arrangements facilitate the adviser's determination, required by Section 28(e), that the cost of the brokerage and research services is reasonable in relation to the value of such services.

The Market for Independent Research Must Remain Vibrant

It has been evident for many years, but most pointedly as a result of the bursting of the late-1990's market bubble, that research created by integrated investment banks is tainted by conflicts created by association with the corporate finance business. In settling the case of tainted research with 10 major investment banks earlier this year, the Commission and other regulators insisted that the settling firms spend $432.5 million on independent research over the next 5 years. The Global Research Analyst Settlement evinces the value of independent research product versus the value of in-house research product of investment banks. Placing unfair burdens on independent research could discourage the growth of the market for independent research, a result that is at odds with the fundamental principles of the Global Research Analyst Settlement. We agree that independent, conflict-free research is an essential element in restoring investor confidence in the markets.

Access to Independent Research

Independent agency brokers offer access to hundreds of sources of independent research, including fundamental and technical research on individual issuers, industry and sector analyses and broad-based economic research. We believe that access to such a wide variety of ideas encourages better decisionmaking on the part of the adviser. Many of the sources of independent research are small businesses with little or no distribution capability. Such boutiques might not survive but for the business provided by independent agency brokers. Independent agency brokers can assist advisers in sourcing independent research and, where available, achieve volume discounts. Independent Research Arrangements provide critical access to research and remain the most viable distribution vehicle for the independent research providers.

Small Investment Advisers Benefit the Most

Small investment advisers typically have small research departments. Many do not have the resources to create an elaborate in-house research infrastructure.

Small advisers benefit the most from having continued access to a wide variety of independent research. Independent research arrangements allow small advisers to compete with the bigger players.

The Current System Works Well

Abuses Are Rare

In 1996 and 1997, the Commission's Office of Compliance Inspections and Examinations (OCIE) conducted a sweep examination of the soft-dollar industry. OCIE issued a report in 1998 detailing its findings (the Sweep Report). OCIE found that approximately 2 percent of commissions paid in purported reliance on Section 28(e) was in fact for "nonresearch products and services." OCIE's finding merits comment.

- First, OCIE's finding of only 2 percent of commissions being used for services outside the safe harbor is remarkably low, particularly considering that, prior to issuance of the Sweep Report, the legislative history, and other guidance on the definition of research for purposes of Section 28(e) was sparse. Indeed, the Sweep Report is the most extensive guidance on the topic to date.
- Second, among the items to which OCIE objected as being outside the safe harbor are proxy services, membership and licensing fees related to investment management certification programs, and services related to regulatory compliance. In most cases, the industry was acting in the good faith belief that many of these products and services were within the safe harbor.
- Third, a corollary to the first two points is that the industry's practices have improved a great deal since the Sweep Report was issued. Once guidance was issued and standards were set, even informally, the industry responded. Independent agency brokers generally, and BNY Securities Group's brokers in particular, have adopted policies and procedures designed to ensure that their practices are consistent with the requirements of Section 28(e) for those clients required or desiring to stay within the safe harbor.

The Sweep Report's Recommendations Largely Have Been Adopted by the Independent Agency Brokerage Industry

The Sweep Report made a series of recommendations to the Commission regarding potential soft-dollar reforms. The primary recommendations were: (1) publication of the Sweep Report to provide guidance to investment advisers and broker-dealers; (2) enhanced recordkeeping by investment advisers and broker-dealers with respect to soft-dollar arrangements; (3) enhanced disclosure by investment advisers of research products and services; and (4) enhanced internal controls.

As noted above, advisers and agency brokers responded to the Sweep Report's guidance by adopting procedures and controls designed to ensure compliance with the requirements of the safe harbor. Independent agency brokers, such as those within BNY Securities Group, provide detailed information to investment adviser clients regarding their brokerage commissions and the services they receive; we also retain detailed records of the products and services provided and information about the research providers. The Securities Industry Association has issued a Best Practices guide on soft dollars that many brokers have adopted wholesale. The Association of Investment Management and Research also issued soft-dollar standards shortly after the issuance of the Sweep Report, which have been adopted widely by the investment adviser community. In addition, the Commission recently proposed rules that would require investment advisers to adopt formal compliance programs.[4] Accordingly, we believe the current system works as intended. We believe, however, that enhanced disclosure about transaction costs would benefit investors (see below).

The Scope of the Section 28(e) Safe Harbor Is Appropriate

As stated by the Commission, "the controlling principle to be used to determine whether something is research is whether it provides lawful and appropriate assistance to the money manager in the performance of his investment decisionmaking responsibilities."[5] What constitutes lawful and appropriate assistance depends on the facts and circumstances and is "not susceptible to hard and fast rules"[6] or "laundry lists" of specified items. This is because the definition of "research" necessarily will evolve along with changes in market practices, investment strategies, and technology. It's up to the investment adviser to determine in good faith whether

[4] *See* Investment Advisers Act Release No. 2107 (February 5, 2003).
[5] Securities Exchange Act Release No. 23170 (April 23, 1986).
[6] *Id.*

a particular product or service is "research" based on the beneficial effect it has on the adviser's investment decisionmaking process.

Market data and the services that typically accompany market data are properly within the scope of Section 28(e).[7] Providers such as Reuters, Baseline, Thomson, and Bloomberg offer highly sophisticated products that include data feeds, quotes, news, analyses, analytics, and customizable functions. These products permit investment advisers to conduct in-depth research of issuers, industries, economic and market factors and trends. Many advisers use these tools to support momentum and quantitative investment and trading strategies. In other words, these products provide just the "research" that should be available to investment advisers under the safe harbor, because they provide lawful and appropriate assistance to advisers' investment decisionmaking process. We believe that singling out such products, as is currently being discussed in the United Kingdom, reflects a bias in favor of "fundamental" over "technical" or other research that is inconsistent with Section 28(e) and marketplace practices. We recommend that the Commission does not narrow the Section 28(e) safe harbor to preclude an adviser from paying for such products.

Hedge Funds and Other Investment Advisers Can and Do Operate Outside the Safe Harbor

Investment advisers to clients other than mutual funds or ERISA plans may use client commissions to obtain services outside the safe harbor, provided the adviser receives client consent. The adviser to a hedge fund is a common example of the type of adviser that receives such services. We believe the perception that soft dollars are abused may relate to the fact that advisers to hedge funds commonly receive services outside the safe harbor (for example, office rent). In most cases, such advisers have received client consent to do so. As such, this is neither an abuse of the Section 28(e) safe harbor nor a matter that requires regulatory intervention.

Enhanced Disclosure

As stated above, we believe the current system works well. Nevertheless, we feel that investors could benefit from enhanced disclosure by investment advisers regarding their soft-dollar practices. As noted in the staff memorandum, the Commission "twice has proposed requiring increased disclosure of quantitative information about the use of client brokerage and the research and services advisers obtain from brokers. Both times the rules were not adopted because of intractable problems in valuing the research and services that advisers receive for soft dollars, tracing the allocation of those benefits to clients' accounts, and quantifying the effect of the benefits on the accounts' performance."[8]

The Commission last proposed such rules in 1995.[9] The rules would have required disclosure on an annual basis of the twenty brokers other than "execution-only" brokers (research brokers) to which the adviser directed the most commissions, and the three execution-only brokers to which the adviser directed the most commissions. For each broker, the adviser would have disclosed the aggregate amount of commissions directed by the adviser to the broker, the percentage of the adviser's discretionary brokerage commission that this represents, the average commission rate paid to the broker, and a description of soft-dollar services provided by the broker.

Goldman Sachs and Morgan Stanley offered an alternative proposal. The Goldman/Morgan proposal would have required explicit disclosure of independent research arrangements, but would have exempted soft dollars used to pay integrated firms, such as themselves. One of the arguments put forth in support of the Goldman/Morgan proposal was that it was too difficult to separate the costs of execution, research, and other services provided as a bundle. The Commission correctly refused to move forward with its rule proposal unless it applied equally to integrated investment banks. Last December, the Investment Company Institute (ICI) issued a letter to the Commission essentially parroting the failed Goldman/Morgan proposal. We find it ironic that during a time when it is more apparent than ever that more disclosure encourages better practices and decisionmaking, the ICI would propose a framework, rejected almost 10 years ago, that would increase the opacity of brokerage commissions.

We offer a different approach. We support enhanced disclosure by broker-dealers to their investment adviser clients regarding the costs of execution, clearance, and

[7] Section 28(e) defines "research services" to include, among other things, advice, either direct or through publications or writings, "as to the value of securities, the advisability of investing in, purchasing, or selling securities, and the availability of securities or purchasers or sellers of securities," and "analyses and reports concerning issuers, industries, securities, economic factors and trends, portfolio strategy, and the performance of accounts."

[8] Staff memorandum at 40.

[9] *See* Investment Advisers Act Release No. 1469 (February 14, 1995).

settlement (brokerage), research and other services provided by the broker-dealer, so long as any requirements are applied equitably to all market participants.

We recognize that average investors would have difficulty understanding detailed transaction cost disclosures. We agree with the Commission that fund independent directors are in the best position to monitor brokerage allocation practices and to protect fund investors' interests. Nevertheless, we believe that investors can benefit from enhanced disclosure of summary information that would provide them with a clearer picture of their advisers' brokerage allocation practices. We favor requiring disclosure of commissions and mark-ups/mark-downs (to the extent they are required to be disclosed in a Rule 10b–10 confirmation) in the aggregate, and broken out into three categories: Execution-only, proprietary research commissions, and independent research commissions. We believe this information will be easily understood by investors and will help them assess their advisers' use of their commission dollars.

Changes Must be Applied Equitably

Any changes to soft-dollar practices, whether in limiting the scope of "research" under Section 28(e) or enhanced disclosure about soft-dollar arrangements, must be made in a way that does not discriminate against market participants. As demonstrated above, the direction of commissions to an integrated investment bank in exchange for access to its analyst is every bit as much a soft-dollar transaction as the direction of commissions in exchange for a Reuters terminal. Moreover, the amount of commissions directed to the integrated investment banks dwarfs the amount directed to independent agency brokers. No reform effort could be meaningful unless it addresses the practice of providing proprietary research.

Conclusion

Independent research arrangements provide a combination of best execution and independent research. Independent research is vital to our financial markets, because it provides advisers access to a wide variety of thoughts and investment ideas, and the absence of conflicts will help restore investor confidence in our markets.

Compliance practices with respect to independent research arrangements are state of the art. Indeed, investment advisers and broker-dealers largely have adopted the Sweep Report's recommendations. Firms have enhanced policies and procedures, training, and recordkeeping in response to the Sweep Report's guidance. Independent research arrangements are transparent and actively managed by investment advisers. Accordingly, we believe the Commission should not enact broad change that could have unintended adverse repercussions.

Although we believe the system currently works well, we believe investors can benefit from enhanced disclosure about how their investment advisers direct brokerage. We support requiring disclosure by investment advisers of the amounts and percentages of commission dollars directed to execution-only firms, independent agency brokerage firms and proprietary research firms (for example, integrated investment banking firms). Most importantly, any contemplated changes must be applied fairly.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR ENZI FROM GRADY G. THOMAS, JR.

Q.1. Last week, a Federal judge approved monies from the $1.4 billion that would go toward financial literacy. How should this money be used to educate investors?

A.1. Interstate Group Division of Morgan Keegan & Company, Inc. was not a party to the referenced civil action, and I am not privy to the terms of the settlement. I do believe that improving the financial literacy of retail investors is a worthwhile cause. One suggestion I have is for investors to be educated as to the importance of consulting several sources of information before making an investment decision, and the differences between various investment research tools, such as independent versus proprietary research.

Q.2. Can we truly improve market transparency or enhance investment governance in the best interest of shareholders, or implement enduring reform, without a widespread expansion of investor comprehension?

A.2. I believe that over the past two decades, the SEC and the securities industry have greatly improved market transparency by way of rapid and broad dissemination of market data (last sale information, quotations, etc.) and improved disclosure of investment practices through the evolution of confirmations, prospectuses, and investment adviser registration documents. In that regard, I support the goal of continuing to improve the dissemination of financial information to investors. I also support actions such as the SEC's "plain English" initiative to provide information to retail investors in a clear, easy to understand format. I do, however, believe that we must take care not to overload investors with information. The danger here is twofold. First, information overload tends to obscure the truly important disclosure from the eyes of investors. Second, the costs of producing and distributing such information are ultimately passed down to investors, lowering investment returns.

Q.3. As a representative from an independent research company, you strongly oppose a ban on soft-dollar commissions for third-party market research. How does your company, and other companies like yours, improve the mutual fund industry from an investor's perspective?

A.3. The Interstate Group Division of Morgan Keegan & Company, Inc. is a registered broker-dealer who provides independent research to our institutional clients, some of whom are advisers to mutual funds. Mutual fund investors reap a number of benefits from arrangements through which broker-dealers like The Interstate Group provide research to mutual fund portfolio managers.

Independent Research Arrangements Improve The Flow Of Investment Research To Investment Managers

When Congress adopted Section 28(e) it was concerned that investors would suffer if the flow of research services to their money managers were impeded. Investment research is the lifeblood of the investment management industry and allows portfolio managers to maximize the performance of their managed accounts. At least one study has suggested that the use of research commission arrange-

ments by money managers is positively correlated with investment returns. Under the rubric of Section 28(e), broker-dealers such as the Interstate Group now provide literally hundreds of independent research services to money managers to assist in the investment decisionmaking process. These services include not only investment information but also fundamental databases, portfolio modeling, and strategy software. The Interstate Group and other broker-dealers have been particularly successful in assisting the development of the independent research community as a viable alternative to proprietary research produced by Wall Street firms. Independent research firms are often small operations who use innovative and unique methodologies and/or who target research at a specific segment of the market not given sufficient coverage by Wall Street. It is difficult for small independent research providers with limited marketing budgets to gain a foothold in the market for investment research. Firms like The Interstate Group provide assistance to independent research firms in gaining market acceptance through the use of research commission arrangements.

Competition Between Broker-Dealers Providing Independent Research Has Reduced Execution Costs To Investors

By becoming major competitors for institutional order flow, brokers such as The Interstate Group have exerted downward pressure on commission rates, thus lowering costs to investors. Since commission rates were unfixed in 1975, execution costs have declined significantly. Prior to 1975, commission rates on institutional trades were on a sliding scale based on volume with a high of $0.82 per share. In 1998, an SEC report found commission rates of about $0.06 per share for those institutional accounts examined by the SEC staff. My experience is that commission rates have further been reduced and today average $0.05–$0.06 per share for institutional trades.

Independent Research Arrangements Allow For Enhanced Competition Between Investment Managers

In its deliberations on Section 28(e), Congress expressed the fear that without access to the research that broker-dealers provide, small investment managers would be pressured to charge higher fees than those charged by large money managers. What was true in 1975 is true today. Many start-up investment advisers cannot establish their businesses and compete with larger money managers without access to research provided by broker-dealers such as The Interstate Group under Section 28(e) arrangements. Enhanced competition between money managers provides more choice to investors while keeping management costs down.

Q.4. Do you think that other proposals, including enhanced disclosure of soft dollars and stiffer penalties for violations, will be strong enough to prevent future abuses of soft-dollar commissions?

A.4. I believe that abuses of soft-dollar arrangements are rare and can be easily dealt with by the SEC using its existing enforcement tools. Indeed, in the last industry-wide examination sweep conducted by the SEC staff in 1997, the staff found no instances ". . . in which [mutual fund] commissions were used to purchase non-

research items, which did not benefit the funds themselves." This being said, I note that the SEC staff did, in Section VIII of the 1998 inspection report that discussed its 1997 examination sweep, make a number of recommendations pertaining to the provision of research for portfolio commissions. I encourage the SEC to give further consideration to these recommendations, and note that many of them have already been adopted by The Interstate Group and other broker-dealers.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR ENZI FROM JOSEPH M. VELLI

Q.1. Last week, a Federal judge approved monies from the $1.4 billion that would go toward financial literacy. How should this money be used to educate investors?

A.1. There are a number of private foundations, such as the Foundation for Investor Education founded by the Securities Industry Association, that are dedicated to raising the level of investor literacy in the United States. These foundations have a variety of programs and web-based tutorials that are available to investors. The track records and reach of these programs should be reviewed so that the settlement monies can go to objective education programs that will have the greatest impact. In addition, the SEC, NASD, and the NYSE all have substantial websites that include investor information sections that could be further supported and enhanced.

Q.2. Can we truly improve market transparency or enhance investment governance in the best interest of shareholders, or implement enduring reform, without a widespread expansion of investor comprehension?

A.2. I agree with you that improved transparency, enhanced investment governance and other reforms, while positive developments for and beneficial to investors, may not be fully understood by them. A better-educated investor would better comprehend these reforms and utilize the improved information and protections afforded to make more informed investment decisions. Investor education is critical to such reforms. However, such reforms, nevertheless, benefit investors.

Q.3. How would the proposed changes to the regulation of soft dollars, especially enhancing disclosure and "unbundling" commission payments, affect your firm?

A.3. Fund boards and individual investors should have more information about how their commissions are being used. The Bank of New York supports enhanced disclosure requirements regarding the use of commissions to acquire research. We believe a policy of greater disclosure will serve investors well, restore their confidence, increase merit-based competition among sources of research, increase competition between execution-only brokers and full-service brokers and, ultimately, benefit the securities industry.

As an agency broker, we already disclose to our asset manager customers the amount of commissions used to pay for research products and services selected by the asset managers—including an itemized list of the research we provided and the cost of each product or service. We believe that all broker-dealers can, and should,

disclose these costs, to the extent they are quantifiable, and make narrative disclosure about what is not quantifiable. We have shared with the staff of the Securities and Exchange Commission a suggested approach to disclosure, a copy of which was included in our submitted materials.

We draw a distinction between the disclosure of research commissions and complete unbundling. The Bank of New York believes that commissions used to pay for research should be accounted for and disclosed. We do not support the full unbundling of commissions by integrated investment banks because such investment banks provide other services, such as capital commitment, as part of their commission. However, to the extent that disclosure drives the market, resulting in a component-priced research product for proprietary research, much like the way third-party independent research currently is priced, we continue to believe that it is appropriate to use commissions to pay for research because the research benefits the investor.

Q.4. If commission unbundling was mandated, how would it affect your relationships with independent and third-party research companies?

A.4. Presently, independent third-party research commissions are effectively unbundled, because each research product component is individually priced. Investment managers know exactly what is paid for execution and each research product component. Accordingly, mandated disclosure of the bundled services would have no impact on third-party independent research companies, assuming that commissions could continue to pay for research.

However, if such unbundling also prohibited the use of commissions to pay for research, this would have a significant adverse impact on independent third-party research companies because smaller investment managers would not be able to afford their products and large money managers would rely more heavily on internal
research because of cost. This further would result in smaller investment managers becoming less competitive in terms of their expenses and would negatively impact the quality of their investment advice and judgment.

AFTERNOON SESSION

The Committee met at 2:35 p.m., in room SD–538, Dirksen Senate Office Building, Senator Richard C. Shelby (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN RICHARD C. SHELBY

Chairman SHELBY. The hearing will come to order.

We have already had a hearing most of the day on mutual funds. We are continuing that, so we may have worn out some of the Members.

This afternoon, the Committee continues its examination of the mutual fund industry. Since the mutual fund scandals broke last November, a number of my Senate colleagues have offered remedial legislation. This afternoon, we are fortunate to have with us several of our colleagues who have advocated such reform. I would like to welcome Chairman Susan Collins, from the Governmental Affairs Committee, and Senators Fitzgerald, Levin, and Akaka. I look forward to hearing their comments on their proposed reform package and the fund industry generally.

On the second panel this afternoon, we will hear from representatives of several mutual funds and broker-dealers. At the beginning of this hearing process, I challenged these two industries to recommit themselves to the ideal of investor protection and demonstrate an ability to abide by it. I believe that an industry so dependent on integrity and investor trust must identify and address potential conflicts of interest and nontransparent practices. Although a few months time is certainly insufficient for final judgment of the industry's response, I do believe that we have a preliminary record to begin to evaluate its commitment to reform. As we near the conclusion of our scheduled hearings, it is important to understand the industry's response to the SEC's slate of proposed rules and to examine whether additional reforms are necessary.

During the course of our hearings, we have learned how the growing role of broker-dealers in fund sales and distribution has significantly changed fund operations. Funds rely on broker-dealers not only to provide brokerage and research services, but also to widely market and distribute their investment products. As the role of the intermediaries has evolved, so too, have the payment and cost structures. Funds employ a number of payment methods such as 12b–1 fees, revenue sharing, and directed brokerage arrangements to enhance the distribution of their products. This hearing will be an opportunity to better understand these practices and their impact on investors.

On the second panel this afternoon, we will hear from Mr. Paul Haaga, Executive Vice President and Director of Capital Research and Management Company and the Chairman of the Investment Company Institute; Mr. Chet Helck, President and Chief Operating

Office, Raymond James Financial; Mr. Thomas Putnam, Founder and CEO of Fenimore Asset Management; Mr. Edward Siedle, Founder and President of The Benchmark Companies; and Mr. Mark Treanor, General Counsel and Head of the Legal Division of Wachovia Corporation.

I thank each of you for appearing this afternoon. Your written testimony will be made part of the record in its entirety. Chairman Collins, I will start with you. Welcome to the Committee.

Senator COLLINS. Thank you, Mr. Chairman. I think Senator Fitzgerald would like to proceed first.

Chairman SHELBY. If you will yield to him. You are the Chairman.

Senator COLLINS. I will. Thank you.

Chairman SHELBY. I will recognize Senator Fitzgerald.

STATEMENT OF PETER G. FITZGERALD A U.S. SENATOR FROM THE STATE OF ILLINOIS

Senator FITZGERALD. Thank you, Mr. Chairman, and I want to at the outset compliment you on the very comprehensive series of hearings you have held in the Banking Committee, and I compliment your reform-mindedness and your independence. You are taking on a lot of important issues, like GSE reform, stock options accounting, and the like. Thank you very much for allowing us the opportunity to appear here.

I want to thank my cosponsors, Senator Collins and Senator Levin, who are also appearing on the panel, and I want to compliment my good friend, Senator Akaka, who is here to talk about a serious reform bill that he has introduced. We also have a very serious bill that has been introduced by Senators Dodd and Corzine, too, who have also come up with some very good ideas.

In our Governmental Affairs Committee, we did two hearings on this issue, and actually a third hearing on the Government Thrift Savings Plan. We spent about 6 months analyzing the issues, and mainly what we concluded is that consumers could be much better protected if there were enhanced disclosure of the types of fees that mutual fund shareholders are charged.

The first thing I want to point out, Mr. Chairman, is that most Americans now are investing in mutual funds. This is a graph that shows by State and percentage of the population. In your State, you have 1.1 million mutual fund shareholders; 24 percent of your State is invested in mutual funds. Overall in the country, 95 million Americans are invested in mutual funds.

Chairman SHELBY. What is the average percentage State by State of the population investing?

Senator FITZGERALD. It is 39 percent, almost 40 percent. In my State, there are 5 million mutual fund investors.

Chairman SHELBY. That is high.

Senator FITZGERALD. And it is not clear to me—in households, if you say 95 million Americans are invested in the markets, then that is a majority of the households, certainly, in America.

Chairman SHELBY. I agree.

Senator FITZGERALD. If you could flip the——

Chairman SHELBY. Involving $7 trillion I believe, is it not?

Senator FITZGERALD. Exactly. Exactly.

Now, if you go back to 1980, the mutual fund industry was very small. There was only $115 billion in assets total in the industry. The growth has been explosive in the last 20 years. It has grown from $135 billion in 1980 to $7.5 trillion that are invested in mutual funds.

When you hear the average fees on mutual funds, they are expressed as a percentage. In fact, the average mutual fund percentage expense ratio is 1.56, 1.5 percent. Now, that sounds diminutive, it sounds trifling, 1.5 percent fees. But if you add that up in dollars, 1.5 percent of $7.5 trillion, you are talking tens of billions of dollars. In fact, probably in total there are close to $200 billion a year being earned on America's savings in mutual funds.

Our main concern that our bill addresses is that a lot of the fees are not disclosed. You would think that as mutual funds' assets have grown, you would think the fees would have shrunk as a percentage of the assets because there are enormous economies of scales in money management. But, in fact, mutual funds' assets have risen. That is the red axis. It has risen. As it has climbed to $7 trillion, it has risen 60 times over in the last 20 years. But fees have risen more. They have risen 90 times over. So what happened to the economy of scale?

What has happened is that, for some reason, there are a lot of mutual funds out there. In fact, there are 8,800 mutual funds. There are only 6,600 publicly traded corporations, but there are 8,800 mutual funds. It tells you it is a pretty good business to start a mutual fund. Most Americans do not understand—are trapped in high-cost funds because I do not think they understand the significance of fees, and it turns out 88 percent of mutual funds underperform the market over time.

Chairman SHELBY. By "the market," is that the S&P, for example?

Senator FITZGERALD. Just the overall market, yes. The overall market funds underperform the overall market.

Chairman SHELBY. Okay.

Senator FITZGERALD. And there is a big difference whether you are in a low-cost fund—if you are in a low-cost fund, imagine a fund with only a 0.15-percent fee. That is 15 cents for every $100 invested. If you invested $10,000 in the low-cost fund and kept it there for 40 years, you would wind up with $205,000 at the end of the 40 years. If you go in a high-cost fund, however, with a percentage point more in fees, you will have substantially less. You will wind up with only $141,000 at the end of 40 years.

It turns out a 1-percentage-point increase in the fees you are paying will cut your retirement nest egg by something close to 45 percent over a lifetime of investing.

Mr. Chairman, what we have sought to do is very clear. The evidence is clear that the lowest-cost quartile of funds dramatically outperform the highest-cost quartile. This is over 10-years returns on equity funds, much higher returns for the lower-cost funds.

Nonetheless, many investors are going into high-cost funds, and I think it is because the fees are ill-disclosed and people do not understand the importance of fees. About half the fees aren't disclosed at all. Those are the transaction costs.

We seek in our bill a very free market solution to this dilemma and, that is, enhanced disclosure. We do not want to regulate fees. We totally believe in a free market, but we want to liberate those free market forces so that you can go look and compare one fund with the other on a cost basis, on an apples-to-apples basis.

I am going to turn this over to Senator Collins and Senator Levin. The other thing I want to mention that our bill does, though, is we do bolster the fiduciary duty that fund directors would owe to fund shareholders. My legal staff has surveyed all the cases and found that it is very rare for a court to find a breach of fiduciary duty on behalf of a fund director or on behalf of a fund adviser. And it turns out that the fiduciary duty that is now in the Federal law is very weak and without content. In fact, no case in the country has ever found a breach of fiduciary duty by an investment adviser, no matter how high their fees were, because the fiduciary duty in our Investment Company Act is very weak. We seek to boost that.

We also go in the same direction as the SEC does in terms of mandating an independent chairman of the board. In my closing, I would just like to rebut a point that was made by Mr. Ned Johnson, the Chairman of Fidelity Advisers, in his op-ed piece in *The Wall Street Journal* on February 17. He argued that it is a bad idea to have an independent chairman of a mutual fund who is different than the chairman of the fund's adviser. And he said it would be akin to having two captains to a ship.

The point I would make is that Mr. Johnson's analogy is wrong because there are two separate ships here: one ship is the mutual fund, in which the consumers are investing; the other ship is the adviser firm, the asset manager firm that Mr. Johnson's family owns. He can be chairman of his asset manager firm, and he owes a fiduciary duty to that. But, in my judgment, I agree with Justice Harlan Fiske Stone, who said that one man cannot serve two masters. How can he both fulfill his fiduciary duties to his adviser, his asset management firm, and the mutual fund?

That is why we do go in the same direction as the SEC, and I would like to point out that I do think Fidelity is a very good fund. They have one of the lowest-cost funds, and obviously they have been successful, in part for that. But I did want to rebut that point of Mr. Johnson's.

Thank you.

Chairman SHELBY. Senator Collins.

STATEMENT OF SUSAN M. COLLINS

A U.S. SENATOR FROM THE STATE OF MAINE

Senator COLLINS. Thank you very much, Mr. Chairman. I want to thank you for inviting me and other Members of the Governmental Affairs Committee. Under the leadership of Senator Fitzgerald, the Committee has spent a great deal of time investigating mutual fund issues, and we hope to be able to share our findings with you today. I want to commend you for your leadership on this issue. I know your Committee has held several hearings, and this issue really matters. As you pointed out, it affects some 95 million American investors who hold assets exceeding $7 trillion that are

invested in mutual funds—funds that are often touted as a safe haven for the small investor.

As the Governmental Affairs Committee pursued its investigation, I thought about a fundamental question: Why is it that in a society built on competition, market forces do not drive down mutual fund fees? Why is it that the legendary American consumer, who will search far and wide for the cheapest gas, clip newspaper coupons, and take advantage of early bird specials, appears to be oblivious to fees that can, over time, affect his or her net worth by thousands of dollars, as Senator Fitzgerald's charts amply demonstrate? Why is it that mutual fund fees seem more impervious to competitive forces than almost any other cost in our society? In fact, the only thing I can think of that is more impervious is college tuition, which seems to not be affected at all by competition among schools.

I start with the basic notion that competition can only work when market participants have adequate information. If mutual fund investors do not fully understand either the level of their fees or the fees' impact on fund performance, then competition lacks one of its essential ingredients. Furthermore, if this is true for many mutual fund investors, then we cannot expect the informed choices and decisions of a majority to protect the uninformed decisions of the minority as occurs in markets that are efficient. This theory would suggest that the Government should act to improve either the amount of fee information provided to investors or the clarity with which it is provided, or both. And I believe that this is the most important reform included in our bill.

What we need to do is to help investors focus attention on the costs of owning mutual funds. For most investors, high mutual fund expenses will cost them far more than such abusive practices as late trading or market timing, which have grabbed the headlines. As Senator Fitzgerald indicated, even a 1-percent difference in fees over a lifetime of investment can result in a 35- to 40-percent difference in the ultimate retirement savings for a worker.

We cannot enjoy the benefits of competition among these 8,000 funds unless we have an efficient marketplace. And an efficient marketplace requires that prices be both transparent and easily accessible to investors. Currently, however, mutual fund expenses and fees are often opaque and obscure. In contrast, historical performance of funds, the rate of return, is well known because successful funds tout their past performance data through large advertising campaigns.

I recognize the impediments to calculating and providing to consumers the true costs of mutual funds. For example, as Senator Fitzgerald noted, mutual fund trading costs, which funds pay to brokers when the funds buy or sell securities for their portfolios, are not included in the expense ratio.

Compounding this problem, there are many expenses that are bundled in with these transactions, which means that even more mutual fund expenses never make it into the expense ratio. They include, for example, research and related costs that are purchased with so-called soft dollars. Another example is the practice of directed brokerage, by which trades are executed with certain brokers that sell the fund's shares and are understood by both parties

to be a form of compensation. This practice, in essence, combines distribution costs with brokerage costs and becomes a hidden 12b–1 fee.

Now, the SEC has made a good start in improving cost disclosure with its recent proposal that mutual funds disclose in shareholder reports, their costs per $1,000 invested. However, I believe that Congress should go further. In our legislation, S. 2059, we would require that such data be published on a shareholder's account statement at least annually. In addition, such data should be personalized for each investor to the extent practical.

It is not enough to tell an investor how much his costs would have been had he owned *x* amount of shares that he does not actually own. Like a bank checking account statement that tells a bank customer how much he or she was charged for individual banking services, a mutual fund statement should tell an investor how much his or her actual share of the fund's fees were.

I recognize, Mr. Chairman, that there would be costs to generating and reporting this personalized data. But, still, having reviewed the analysis done by the General Accounting Office, I have concluded that this disclosure is warranted, it is needed, and would be welcomed by consumers. It is not that expensive.

GAO estimates it would cost about 65 cents each year for the individual accountholder. And GAO has recommended that the SEC seriously consider requiring that types of disclosure. As I have said, the SEC has not gone that far. I hope this Committee will.

In view of the number of witnesses you have today, I would ask that the balance of my statement be put in the record. And, again, I commend you for your leadership in this area.

Chairman SHELBY. Without objection, your statement will be made part of the record.

Chairman SHELBY. Senator Levin.

STATEMENT OF CARL LEVIN

A U.S. SENATOR FROM THE STATE OF MICHIGAN

Senator LEVIN. Mr. Chairman, thank you for holding this important hearing, for listening to those of us who are just part of the numbers of Senators who are deeply concerned about these mutual fund problems that were disclosed about 7 or 8 months ago. In particular, I also want to thank this Committee for the very prompt response to the corporate scandals of 2002, the Enrons, the WorldComs and the Tycos. This Committee led the way with a bipartisan effort. We adopted in Sarbanes-Oxley, a real reform that has made a difference, and we hope this Committee will also act promptly relative to the need for mutual fund reforms indicated by recent events in that area as well.

Late trading, market timing, hedge fund favoritism, hidden fees, and other abuses have undermined public confidence in this industry. Senator Fitzgerald has been a tremendous leader in this bill. I am proud to join with him. Our Chairman, Senator Collins, as always, has been very supportive and helpful in the efforts of her Committee and in the oversight role of that Committee, in this case relative to mutual funds, and I am proud to join them and other supporters of this legislation.

The Mutual Fund Reform Act was introduced in February. It addresses a number of the issues which you have already heard about in the last few minutes, but I want to just focus on the conflicts-of-interest component of this bill.

It troubles me greatly that people who are selling me mutual fund shares or advising me on investments are, on the one hand, being paid a fee by me at the same time they are receiving financial rewards from the mutual funds that they are promoting. And the issue is: What do we do about that?

There is an inherent conflict of interest when someone who is saying to me "buy this mutual fund" is receiving from that mutual fund a benefit.

I think most people say that is wrong. There is a conflict in there. "You can only serve one master," as Senator Fitzgerald quoted properly. We have to really make a decision here as to whether, it is going to be tolerated in the future that we can have a situation where a broker or a financial adviser is receiving the fee from the investor to advice on a mutual fund at the same time that adviser is receiving an incentive to promote that mutual fund from the mutual fund itself.

And there are two alternatives here. One is to ban it because it is an inherent conflict of interest. The other one is to disclose it. And these alternatives are really what, it seems to me, the tug of war is about. It is clear we have to do something. To me, banning it is right because it is an inherent conflict of interest. Disclosing this conflict of interest does not address the conflict. All it does is say to an investor, if he or she can understand it—because these are complicated issues—there is a conflict of interest. But that frequently gets buried in verbiage. We have seen these disclosures, for instance, on other things, on telephone bills and on long distance, on pharmaceutical purchases, and a whole lot of areas. These disclosures do not do the job, number one. But, number two, they do not address the fundamental problem here, which is that you have a conflict of interest. Disclosure does not correct and cleanse the conflict.

Chairman SHELBY. You are saying basically that if you disclose a wrongdoing, that does not cure the wrongdoing.

Senator LEVIN. It does not, and there are two forms that I want to just to spend 30 seconds or a minute on: the so-called revenue sharing and the directed brokerage. And what it amounts to is this. If a mutual fund has an agreement with a broker or financial adviser that they will purchase from that broker stock for their own inventory, for their own portfolio, if that broker will promote its mutual fund to those investors, those 95 million investors out there, you have got an inherent conflict.

The other form, which is called revenue sharing, is when a mutual fund tells the broker, if you will promote my fund to those 95 million people out there, I will give you a share of the profits of my fund. There is an inherent conflict because the broker or the financial adviser there is not only being paid, on the one hand, by the person who is benefiting from the sale on the sale end, but also getting a fee from the person who is purchasing that share in the mutual fund.

Those are two, it seems to me, inherently conflicting situations.

Chairman SHELBY. Could the SEC ban that?

Senator LEVIN. We hope they can. We hope they have got the legislative authority, but you can strengthen their hand. In the one case, they are proposing to ban it. In the other case, they are proposing to disclose it. In the case of the revenue sharing, the SEC is proposing disclosure. In the case of directed brokerage, they are proposing a ban. But it is important that the Congress strengthen their hand, give them the clear authority, hopefully, to ban both since there is an inherent conflict and disclosure does not solve the conflict but, in any event, to support their efforts. The SEC has taken important steps, and legislatively we can give them a greater legal hand, it seems to me, if we give them the clear statutory authority.

There are other conflicts which we address in this bill, but I just wanted to focus on two of them because they really need the attention of the Congress, and we hope that this Committee will again lead the way in the Senate toward bringing a strong bill to the floor so that we can get on with restoring the credibility which this industry needs and deserves, for the reasons given. The Chairman has already indicated it is a $7 trillion industry. This is a big chunk of our economy. There are 95 million people relying on this industry for their retirement, buying a house, or educating their kids. So this is a big chunk of the economy, and we look forward to this Committee's continuing leadership in this reform effort.

Thank you, Mr. Chairman.

Chairman SHELBY. Thank you.

Senator Akaka.

STATEMENT OF DANIEL K. AKAKA
A U.S. SENATOR FROM THE STATE OF HAWAII

Senator AKAKA. Mr. Chairman, I thank you very much for holding this hearing and for giving me the opportunity of participating in it. And I want to thank you for what you have done in addressing this problem.

The mutual fund industry, Mr. Chairman, and its reform is important to our country because 95 million people have placed their trust and significant portions of their future financial security into mutual funds. And I must tell you that Hawaii has approximately 371,000 investors in mutual funds. Mutual funds provide middle-income Americans with an investment vehicle that offers diversification and professional money management. Mutual funds are what average investors rely on for retirement, savings for children's college educations, or other financial goals, and even for their dreams.

Last fall, I was appalled by the flagrant abuses of trust among mutual fund companies. So, I introduced S. 1822, the Mutual Fund Transparency Act of 2003, to bring about structural reform in the mutual fund industry, increase disclosures in order to provide useful and relevant information to mutual fund investors, and restore trust among investors.

I want to commend the SEC for its proposals to improve the corporate governance of mutual funds and to increase the transparency of mutual fund fees that investors pay. The proposed requirement for an independent chairman for mutual fund boards,

increased percentage of independent directors to 75 percent, and development of a confirmation notice so that investors will be able to know how their broker gets paid in mutual fund transactions are a solid and measured response to the litany of transgressions which have undermined public confidence in the mutual fund industry. These provisions mirror those in my legislation. In addition, I have been impressed with the SEC's attempts to address point-of-sale disclosure.

However, I continue to believe that legislation is necessary to codify some of the proposed regulations so that the reforms will not be rolled back in the future. It is also important to legislatively address areas where the SEC needs additional statutory authority to address problems and abuses in the mutual fund industry. Legislation is necessary to ensure corporate governance improvements apply these rules universally among mutual funds. Finally, additional legislation may be necessary if disclosures of revenue sharing agreements and portfolio transaction costs are not adequately addressed by the Commission.

S. 1822 includes a number of provisions that are important for Congress to enact. Boards must be strengthened and more independent to be more effective. Investment company boards should be required to have an independent chairman, and independent directors must have a dominant presence on the board. My bill strengthens the definition of who is considered to be an independent director. It also requires that mutual fund company boards have 75 percent of their members considered to be independent. To be considered independent, shareholders would have to approve them. In addition, a committee of independent members would be responsible for nominating members and adopting qualification standards for board membership. These steps are necessary to add much needed protections to strengthen the ability of mutual fund boards to detect and prevent abuses of the trust of shareholders.

To increase the transparency of the actual costs of the fund, brokerage commissions must be counted on as an expense in filings with the SEC and included in the calculation of the expense ratio, so that investors will have a more realistic view of the expenses of their fund. Consumers often compare the expense ratios of funds when making investment decisions. However, the expense ratios fail to take into account the cost of commissions in the purchase or the sale of the securities. Therefore, investors are not provided with an accurate idea of the expenses involved. Currently, brokerage commissions have to be disclosed to the SEC, but not to individual investors. Brokerage commissions are only disclosed to the investor upon request. My bill puts teeth into brokerage commission disclosure provisions and ensures that commissions will be included in a document that investors actually have access to and utilize.

I know soft-dollar practices, Mr. Chairman, were discussed during hearing this morning. The inclusion of brokerage commissions in the expense ratio creates a powerful incentive to reduce the use of soft dollars. Soft dollars can be used to lower expenses since most purchases using soft dollars do not count as expenses and are not calculated into the expense ratio.

There have been calls for the prohibition of soft dollars. However, my bill provides an immediate alternative, which is an incentive for funds to limit their use of soft dollars by calculating them as expenses. If commissions are disclosed in this manner, the use of soft dollars would be reflected in the higher commission fees and overall expenses. This makes it easier for investors to see the true costs of the fund and compare the expense ratio of funds.

Some may argue that this gives an incomplete picture and fails to account for spreads, market impact, and opportunity costs. My bill merely uses what is already reported and presents this information in a manner meaningful to investors.

One of the provisions in my bill requires the SEC to conduct a study to assess financial literacy among fund investors. This study is necessary because any additional disclosure requirements for mutual funds will not truly work unless investors are given the tools they need to make smart investment decisions, and we must first know what education exists.

Mr. Chairman, I look forward to working with you, my colleagues, and the SEC to address problems identified in the mutual fund industry. Thank you very much, Mr. Chairman.

Chairman SHELBY. I want to thank all of you. I have a few questions. It is not every day we have a bipartisan effort here, two Republicans, two Democrats, on a very important issue.

Senator Levin, on the conflict, I think you touched on something just a few minutes ago. If you just disclose a conflict and do nothing about it, there is still a conflict, isn't there?

Senator LEVIN. I am afraid so.

Chairman SHELBY. And a lot of the people might not even recognize it as a conflict. Isn't that one of your concerns?

Senator LEVIN. The fear is that if it is just simple disclosure, the verbiage which surrounds it may not be easily understood by that average investor who does not have a lot of time to pore over that verbiage and words. So particularly where the inherent conflict is not resolved, it is still there, as you just pointed out. There are some things where disclosure is fine. If you are disclosing side effects of a drug, well, if you read about that, you still may want to take the drug even though it may give you headaches or stomachaches. But here the question is whether or not that conflict is something which should be corrected or whether we should tolerate and accept that conflict.

I do not think we should accept these fundamental conflicts as to who is the beneficiary of a sale of a share in a mutual fund. Do we want the person who is selling that mutual fund to be paid by the mutual fund at the same time they are getting a fee from the person they are selling to?

Now, it is worse when that person does not know about it. The question is if somehow or another this conflict is surrounded by verbiage, will that be enough knowledge for that investor to say, well, I understand there is a conflict here, but I will take a chance that you are really giving me advice in my interest rather than lining your own pocket with that money that you are getting from the mutual fund. I do not think we can assume that most investors are going to take the time to understand the language which surrounds that disclosure.

Chairman SHELBY. Does the SEC in your judgment have the power to ban this conflict if it had the will to do it?

Senator LEVIN. I am not sure it does. I hope it does. In one case, it bans it; in the other case, the conflict I mentioned, there is simple disclosure. But I do not know for sure that it does.

Chairman SHELBY. It would be an inconsistent message, would it not?

Senator LEVIN. Very inconsistent. But even if it has the legal power to do it——

Chairman SHELBY. It has to have the will, too.

Senator LEVIN. Exactly, it has to have the will. But as Senator Akaka points out, too, when you put something in legislation, it is stronger because it cannot readily be changed, as a regulation can. But I would say that there is always the possibility of a legal challenge. I do not know of any power that a regulatory body has that cannot be subject to some legal challenge or another. Very few of them have that clarity, and I think we should reinforce their case in case it is challenged.

Senator FITZGERALD. May I interject on this point? The one thing the SEC definitely cannot ban is soft-dollar transactions because that is——

Chairman SHELBY. It is statutory, is it not?

Senator FITZGERALD. —in Section 28(e), I guess it is, of the Securities Exchange Act. It is a safe harbor. And so we have to act, and that is something even, as I understand it, the ICI has come out for banning those soft-dollar arrangements.

Chairman SHELBY. Should they be banned or disclosed?

Senator FITZGERALD. Well, the reason we say they should be banned is because if you get into trying to disclose all these shadow transactions, you will create a document dump on the consumer that will only succeed in confusing him. And we believe you have to keep the disclosure as simple as possible.

On soft dollar, for example, funds will still be able to go out and buy some research or buy Bloomberg terminals for every desk. But what they cannot do is permit a brokerage firm to charge the fund shareholders an exorbitant brokerage fee in return for having the brokerage firm provide those Bloomberg terminals on everybody's desk. They are running up costs for shareholders in an underhanded way that troubles me greatly. And your statement that you do not cure wrongdoing by disclosing it hits the nail on the head.

Chairman SHELBY. That was Senator Levin's statement, and I just picked up on it.

Senator FITZGERALD. It is great. But I think some of these other things the SEC probably can ban. SEC cannot redefine "independence" of the directors.

Chairman SHELBY. The reason we are asking these questions, we are going to have the SEC up here. It will be our last hearing. We want to be prepared for what the SEC can do, has the will to do, and so forth, what they cannot do or what is murky, because I think those are relevant to our hearings.

Senator FITZGERALD. We have a list of things they cannot do, and we will share that with your staff.

Chairman SHELBY. We will share that with our Committee.

Senator Collins, what about the 4 p.m. closing? Have you spent some time on that?

Senator COLLINS. I support the SEC's proposal for a hard 4 p.m. closing. I think that makes a lot of sense and would deal with the late trading problem.

Chairman SHELBY. What do you say to people in Hawaii, Senator Akaka's people, or California, if you have a 4 p.m. Eastern time closing? We have got all these time zones. This question has been asked right here at the table, we will ask the Chairman of the SEC on it, too, because you have the time zone issue, as Senator Akaka knows very well.

Senator COLLINS. You do.

Chairman SHELBY. You have to weigh it.

Senator COLLINS. Exactly.

Chairman SHELBY. Senator Akaka, do you have any concerns since your constituents are from Hawaii and they would have a 4 p.m. closing?

Senator AKAKA. Mr. Chairman, you have put your finger on one of the concerns. I am glad to hear from the industry that they are aware of this problem and they are working to address it.

Chairman SHELBY. Okay. Senator Fitzgerald, let us start with you. What about the proposed independent chairman? If you are going to mandate that you have 75 percent of the directors be independent—I am just posing the question—why should you say that the chairman has to be independent, too, when the other directors elect the chairman? In other words, you have got three-fourths of the boards members that will be independent. They could elect a chairman or not elect one. Why should we do that? This question has been asked.

Senator FITZGERALD. The mutual fund industry just has a bizarre setup because if you and I are shareholders in a mutual fund, let us say ABC mutual fund, we are the owners of the fund. But the way it is set up in America is an outside firm, which is the principal supplier or adviser to the fund, winds up dominating the fund.

So the ABC adviser firm, which is owned by somebody else, the officers of which owe a duty of loyalty and fidelity to ABC adviser firm, they wind up controlling ABC mutual fund that is really owned by you and me. And they also owe a duty of loyalty and fidelity to us. But sometimes the interests of—when they are trying to serve two masters, the interests diverge with the scandals——

Chairman SHELBY. Do all mutual funds do it the same way?

Senator FITZGERALD. All except Vanguard. Vanguard is the only one that is set up where the fund shareholders actually own the——

Chairman SHELBY. They do it all inside.

Senator FITZGERALD. —Vanguard Group, and they did explicitly to eliminate the conflicts and, interestingly, they are by far the lowest-cost mutual fund in America because they competitively bid out the management services and they get much lower costs.

With the scandals you saw breaking, you saw directors engaging in behavior that harmed the fund shareholders but benefited the management companies that they also work for. I believe we have to recognize that the mutual fund and the outside adviser are two

separate ships, and you need somebody looking out on the fund shareholder side.

You know, in politics, when somebody tells us they are neutral and we have a hard time deciding whose side they are on? Pretty good bet if you do not know whose side they are on, they are not on your side. I think when I look at the mutual funds, I see a lot of instances in which the boards have been engaging in behavior that suggests they are not fully on the fund shareholder side.

Chairman SHELBY. Senator Collins, how would you define the fiduciary relationship that the management of the mutual fund owes to the shareholders?

Senator COLLINS. Well, I think that is one of the problems. I think we need an explicit statement in the law that the management of the mutual fund owes the fiduciary duty to the shareholders of the fund. And that is not clear right now.

But there was another point that I just wanted to touch on if you will allow me, and that is, in addition to the issue of how many independent directors and whether the chairman should or should not be required to be independent, we have found that directors tend to serve on many, many different fund boards within a family of funds.

Chairman SHELBY. I have heard 80. Somebody served on 80.

I do not know how much time they spend on that board.

Senator COLLINS. That is my issue. What we have found were several cases where the director was serving on over 100 boards. And I wonder if the real question here is not whether or not the person is an independent director, but whether you can serve on 113 mutual fund boards and really devote the attention and oversight that you need.

I realize that a lot of these funds are very similar and they may be in the same family. But, nevertheless, I do not know how anyone could be an aggressive board member fulfilling that oversight responsibility if you are stretched that thin.

Chairman SHELBY. I do not know about you Senators, but I am on enough committees and subcommittees, and if you do due diligence to any of them, you are still strained, aren't you?

Senator COLLINS. Absolutely.

Chairman SHELBY. Senator Levin, what about the fiduciary duty? Shouldn't it be of the highest order?

Senator LEVIN. I think so, and it should be defined and clear so there is no ambiguity about it to whom you owe your loyalty. And I think the clearer, frankly, the better. When you come to fiduciary duty, there should not be ambiguity as to where you owe your allegiance.

Chairman SHELBY. Senator Akaka, do you agree with that?

Senator AKAKA. Yes. Mr. Chairman, I ask to be excused at this point in time.

Chairman SHELBY. Certainly, and thank you.

Senator FITZGERALD. You know, that is one of the areas the SEC cannot do. Only Congress can amend that. Right now the Act recites a fiduciary duty, but there is no content to it and no case has ever found a breach of fiduciary duty.

Chairman SHELBY. I think one of the purposes of all these hearings is, one, to get to the bottom of the scandals, what caused it,

how you can avoid it in the future; what is the role of the SEC, their proper role, according to statute what they can do and what they cannot do; what do we need to do, if anything. And we start with these hearings.

I appreciate your appearance and your leadership on these issues. We look forward to your participating in some kind of solution to this. Thank you very much.

Senator FITZGERALD. Thank you, Mr. Chairman.

Senator COLLINS. Thank you, Mr. Chairman.

Senator FITZGERALD. And may I have leave to introduce my full statement as well as——

Chairman SHELBY. Without objection, all of your statements will be made part of the record.

Senator FITZGERALD. —a letter from John Bogle endorsing our bill.

Chairman SHELBY. Absolutely.

Chairman SHELBY. Our second panel, if you will come up while the other one is making an exit.

We welcome all of you on the second panel to the Committee. Your written testimony will be made part of the hearing record in its entirety. We hope you will sum up your remarks because we do have a few questions.

STATEMENT OF PAUL G. HAAGA, JR.
EXECUTIVE VICE PRESIDENT
CAPITAL RESEARCH AND MANAGEMENT COMPANY
CHAIRMAN, INVESTMENT COMPANY INSTITUTE

Mr. HAAGA. Thank you very much. Good afternoon, Chairman Shelby, Members of the Committee staff. My name is Paul Haaga, Executive Vice President and Chairman of the Executive Committee of Capital Research and Management Company. Capital Research is the investment adviser to The American Funds Group, the third largest U.S. mutual fund group, with more than $500 billion in assets under management. I also serve as Chairman of the Board of Governors of the Investment Company Institute, and I appear here today on behalf of the Institute and its members.

Chairman SHELBY. That is the trade association of mutual funds.

Mr. HAAGA. It is the association of mutual funds, yes. This afternoon, I will discuss how the industry and regulators have been responding over the past several months to the unfortunate and very disappointing revelations of abusive trading practices in the mutual fund industry. But I want to begin by recognizing the key role that this Committee and Chairman Shelby, in particular, have played in responding to the problems that have occurred.

It is very important for the Committee to engage, as it has been doing, in a thorough and deliberate process of gathering information from all interested parties to help determine what actions may be needed to ensure that the interests of fund shareholders are served. I thank you, most sincerely, for your efforts and especially for giving me an opportunity to participate in today's hearing.

Having worked with mutual funds for over 30 years, beginning as an attorney on the SEC staff, I am outraged and personally offended that some mutual fund officials and others appear to have temporarily ignored the guiding principle by which we all must

live: Our fund shareholders always come first. I look forward to a time in the future when the wounds have healed and we can look back on these events from a broader perspective and once again speak proudly of mutual funds' record of integrity. I have several thoughts on what we need to do to reach that point.

First, Government officials must continue investigating and taking forceful actions against wrongdoers.

Second, regulatory reform is necessary to address late trading, abusive short-term trading, and selective disclosure of portfolio holdings.

Third, as painful as this process has been, it has also presented all of us with a golden opportunity to make improvements that go beyond the specific problems that have been revealed, but that will further reinforce protection and enhance the confidence of fund investors. The institute, the SEC, and the Congress have seized upon this opportunity, and I look forward in the questions to elaborating on some of those efforts.

Finally, as we take advantage of the opportunity to improve what is already a strong regulatory system, we must reject changes that, while well-informed and well-intentioned, would have harmful consequences. It would be most unfortunate if the late trading and market timing problems were used as a predicate for making changes that are not cost-effective and fostering the interests of fund shareholders. These problems are serious, and they must be readdressed. But we should not lose sight of the fact that mutual funds still offer the best and least expensive way for millions of Americans to invest in the securities markets and reach important financial goals.

To serve investors' best interests, reforms should preserve the industry's defining characteristics rather than making changes that would render the industry less entrepreneurial, less competitive, less creative, and less responsive to investors' changing needs.

On behalf of the Investment Company Institute and the entire mutual fund industry, I pledge our continued commitment to take necessary steps to make sure that fund shareholders are fully protected.

I thank you again for the opportunity to testify and I would be happy to respond to any questions.

Let me ask the Chairman, if I can take one more minute.

Chairman SHELBY. Go ahead.

Mr. HAAGA. I would like to respond to something in the charts. You hear a lot of numbers thrown out about expenses and fees in the funds and have they gone up and have they gone down. And I want to give one word of advice to everybody, is just be careful of simple unweighted averages. They can be misleading.

Let me use a simple example. Let us say that our funds are the only ones in the industry, American funds are the entire industry. Among our largest funds, our average fees are 65 basis points, so that is also the industry average. Now, if my friend, Tom Putnam, starts up the FAM Group of—Fenimore Group of that mutual funds, his average fees on his large funds are 1.25 percent. If you are looking at average fees in the industry, they have now jumped to 0.95 percent, nearly a 50 percent increase. That is a lot of what has been happening in the 1990's. Average fees have gone up be-

cause small new fund groups have started and they tend to be of the more expensive types of funds to manage, international funds, growth funds, et cetera. Nobody raised their fees. Our fees stayed at 65. His fees are 1¼, and yet the industry average just jumped 50 percent. Be careful if you read that.

I might also point out that the 1.5-percent number is a simple unweighted average. If you look at the weighted average, which is actually what is happening to shareholders, that is about 1 percent. Total costs, that is all in, the costs of buying shares and owning them, have declined by about 40 percent since 1980. You need to look at the total cost, not just the fund expenses.

Finally, I would point out that 77 percent of shareholders own funds with lower than average cost. That tells us that shareholders are not paying the average costs. I think it also tells us that they understand very well what the costs are and they are voting with their feet for the less expensive funds.

Thank you very much for letting me add that.

Chairman SHELBY. Thank you very much, Mr. Haaga.

Mr. Helck.

STATEMENT OF CHET HELCK
PRESIDENT, RAYMOND JAMES FINANCIAL, INC.

Mr. HELCK. Thank you, Chairman Shelby.

I am Chet Helck, President and Chief Operating Officer of Raymond James Financial and a member of the board of directors of the Securities Industry Association. I am honored to be here today and present our views on this important subject.

I have three points I would like to make to you today, and these points are set out in greater length in my written submission, but I think I can summarize them as follows.

First, mutual funds have been and should continue to be the basic investment vehicle for most Americans and partly small investors. Second, many investors need financial advice from trained professionals to make mutual funds an effective part of their financial plans. The present mutual fund compensation structure makes that possible. Third, the mutual fund distribution system works for the benefit of investors. We support improved disclosure, but we do not believe that the current distribution system is fundamentally flawed. Let me make each of these points in turn.

First, mutual funds allow investors, and particularly small investors, to obtain professional management of their investment dollars. Investors can diversify a relatively small investment which is essential for both growth and safety. Half the households in America trust mutual funds with their hard-earned dollars and for good reason. Mutual funds have helped turn Americans from a country of savers to a country of investors. Mutual funds help investors pay to support their standard of living, educate their children, and provide for their retirement.

Second, more than ever, investors need sound investment advice. I represent some 5,000 financial advisers at Raymond James, and thousands of others around the country whose firms are members of the Securities Industry Association. We are proud of the work we do and the services we provide to our customers. Most Americans know that they must save during their working days and in-

vest wisely for their retirement years. Many investors want assistance when making their financial choices. To be sure, there are those investors who believe they can do it themselves, select the proper mix of fixed income and equity investments, adjust those portfolios on a regular basis and select from the enormous panoply of financial products to meet their needs. But for most of us that is a daunting task and not one that can be safely done in our spare time. This Committee is addressing issues that go directly to the compensations structure that supports the financial advisers who help their clients.

Broker/dealers receive compensation from the funds for evaluating thousands of mutual fund choices, for educating its financial advisers, providing costs associated with comprehensive investor reporting, and for advisory services provided to clients such as financial planning, portfolio review, and performance reporting for the investors. The compensation streams from fund complexes to broker/dealers support these services that investors want and need.

At Raymond James, we sell over 11,000 mutual fund share classes. That includes load and no-load funds. To support those sales efforts and provide investor reports to clients, provide them with comprehensive tax information, and combined critical information on one consolidated statement, it costs us roughly $30 million a year. In addition we spend well over $7 million a year to educate our financial advisers. We do that to help our advisers make sound recommendation to their customers.

My third and final point is that we agree that we must improve the investing public's awareness of the compensation systems and how they affect the costs of mutual fund ownership. The current system for distributing mutual funds benefits investors, there is certainly room for improvement, but that improvement should be undertaken from a perspective that recognizes that mutual funds have been a significant component in making financial security for generations of Americans possible.

We have all read about abuses in the mutual fund and securities fund industries. We agree that abusers should be rooted out and punished. We condemn abuses of fiduciary duties and urge where appropriate, swift, and sure penalties for the wrongdoers. We should make improvements to restore public confidence in this critical vehicle, but if this Committee or the regulatory community leaves American investors with the impression that they cannot trust mutual funds and should regard the product and all those who distribute it with hostility, that will ill serve the very investors you are dedicated to protecting.

At Raymond James, we have always believed in good disclosure, and that is a fundamental part of our client service philosophy. There needs to be improvement overall in disclosure of these different ways of compensating broker/dealers. The SEC has proposed a disclosure format for confirmations of point of sale disclosure that addresses many of these issues. We and others in the industry will be commenting on these proposals in an effort to make them useful and meaningful to investors. While we agree that disclosure should be improved, we believe it should be disclosure that is meaningful, concise, and understandable, and above all, relevant to investor needs.

We think the SEC does have the authority it needs to provide for that disclosure, and we in the industry propose to help them do it. We want to join in making the system better, and we do not want to make the mistake of thinking we have to create a new one in its place.

Thank you for inviting me to testify.

Chairman SHELBY. Thank you.

Mr. Putnam.

STATEMENT OF THOMAS O. PUTNAM
FOUNDER AND CHAIRMAN
FENIMORE ASSET MANAGEMENT, INC./FAM FUNDS

Mr. PUTNAM. Chairman Shelby, Members of the Committee, it is an honor to appear before you today. My name is Tom Putnam, and I am Founder and Chairman of Fenimore Asset Management, a small investment advisory firm with 30 employees in rural upstate New York.

We manage investment portfolios for about 400 individuals and institutions and we offer two mutual funds. I serve as co-portfolio manager for each of the FAM Funds, which have combined assets of about $700 million and approximately 25,000 shareholders. In addition to my varied duties at the firm, I also serve as Chair of the Small Funds Committee of the Investment Company Institute.

First let me express my deep disappointment about the events that have brought us here today. Investors' trust in the entire mutual fund industry has been shaken, and rightfully so, by the current revelations of wrongdoing. In an industry based on fiduciary principles, there is simply no place for this kind of behavior.

I am pleased that the SEC and State officials have moved very quickly to investigate and punish those responsible. I also applaud the SEC's swift action in developing regulatory reforms aimed not only at remedying immediate problems such as late trading, but also addressing potential conflicts of interest, strengthening fund governance, and enhancing standardized fund disclosures. These are sweeping reforms that will benefit investors for years to come.

This Committee also has played a critical role by thoroughly examining the recent scandals and thoughtfully considering what steps are necessary in response. I hope that my perspective, as a founder of a small mutual fund group, will assist you in this important effort.

Specifically, I would like to share with you my thoughts about the impact of regulatory changes on small fund groups. My written statement explores this issue more fully and also provides my views on some of the specific reform proposals that have been advanced. I hope my testimony today clearly conveys my strong support for the tough reforms undertaken by the SEC to date.

Let me also say this: If other proposals are shown to clearly benefit long-term mutual fund investors, I am very likely to support them, and my firm would find a way to bear the associated costs. At the same time, however, I have serious concerns about the enormous number of changes proposed for our industry.

Former Senator William Armstrong testified before this Committee and said he counted 106 pending reforms. My fear is that some of the proposals might be approved in the name of reform

without any real basis of whether they are likely to achieve benefits for shareholders that begin to justify their costs. For small fund groups, with our smaller asset bases and thinner profit margins, the cost could be prohibitive.

Small mutual funds can be easy to overlook, in part, because we do not have the immediate name recognition that many of our larger fund groups enjoy. In fact, if you look at the number of fund groups in the industry, small groups constitute a substantial majority. Of the approximately 500 fund groups in the United States, more than 370 of them have assets under $5 billion or less. By comparison, a large fund group may have hundreds of billions of dollars under management.

Small fund groups like FAM Funds provide a greater choice for investors and help foster competition. Small mutual funds typically find a niche and stick with it, achieving success by staying within their circle of competency, rather than trying to be all things to all investors. In addition, a small mutual fund group typically can provide its shareholders a level of individual service and attention, such as providing access to fund portfolio managers that simply is beyond the reach of a large fund group with millions of shareholders.

Finally, it is important to note that many of the most innovative fund products and services, such as money market funds, were introduced by entrepreneurs new to the industry. As this Committee considers whether additional steps are necessary to respond to the recent scandals, I respectfully request that you bear in mind the law of unintended consequences.

No proponent of mutual fund reforms wants to damage the long-term competitiveness and creativity of this industry which is so vitally important to millions of lower and middle-income investors. Yet, if the scales are tipped so that the regulatory restrictions and costs of managing mutual funds outweigh the possible rewards, there could be a brain drain. At the very least, the brightest portfolio managers might be drawn away from the mutual fund industry to more creative and lucrative forms of money management.

New firms simply might not enter our industry at all, choosing instead to limit their investment offerings to less-regulated products. The creativity to provide new investment funds that would be advantageous to lower- and middle-income investors might be stifled, if not lost. If one proposal creates a barrier to entry for a mutual fund entrepreneur, that would be tragic.

I hope these observations about the potential threat of overregulation are taken by the Committee in the spirit in which I offer them—as constructive commentary based on my 30 years of serving individual investors and my strong belief that a vibrant, competitive mutual fund industry serves our Nation's interests.

Please allow me to share with you one final observation. It is clear to me that the problems that have been found in the mutual fund industry cannot be fixed solely by changing rules and regulations. Rather, the industry itself, fund group-by-fund group, must renew its commitment to act in accordance with the highest standards of ethics, morality, and integrity. This has always been an integral part of our philosophy at Fenimore, and I firmly believe that these values have served our shareholders well.

I thank you for the opportunity to participate today.
Chairman SHELBY. Thank you for your statement.
Mr. Siedle.

STATEMENT OF EDWARD A.H. SIEDLE
PRESIDENT, BENCHMARK FINANCIAL SERVICES, INC.

Mr. SIEDLE. Chairman Shelby, Ranking Member Sarbanes, Members of the Committee, thank you for the opportunity to appear before you today to discuss the crisis of confidence in the mutual fund industry.

I am the Founder and President of Benchmark Financial Services, Inc., a firm that investigates money management abuses primarily on behalf of public pension funds. The matters we examine typically involve esoteric breaches of fiduciary duty by brokers, money managers—many of whom manage mutual funds—and pension consultants.<k>

I have worked in financial services for over 20 years. I originally started as an attorney with the Division of Investment Management of the SEC in 1983. Subsequently, I served as Associate Counsel and Director of Compliance of the Putnam Companies.

From 1990 through 1997, I owned a soft-dollar brokerage firm, so I have a great deal of familiarity with the soft-dollar industry.

Years ago, unfortunately, I was referred to in an article as the "Sam Spade of money management," and I am sorry to say the name has stuck with me. I have also been called "the Nation's most vocal critic of money management abuses." Over the past 10 years, I have written about, and spoken about, illegal and unethical activity in the mutual fund industry. In the course of the investigations my firm has undertaken, I have collaborated with the FBI, law enforcement, and the SEC to actively pursue those involved in wrongdoing involving the mutual fund industry and the money management industry, in general. It is a real pleasure, after so many years in the industry, to witness the dawn of an era of heightened public scrutiny of mutual fund practices.

The harm to investors related to the mutual fund industry's betray of the public trust is tremendous. How big is the price tag? It is clear to me that over the years a significant portion of mutual fund investment advisory fees that investors have paid is excessive.

Our firm, in 2003, conducted a survey of 100 pension funds and the investment advisory fees they actually pay. The findings from our survey indicated that the pricing of institutional investment advisory services is somewhat irrational; that is, even institutions sometimes pay excessive money management fees. We found that some pensions are actually paying as much as four times the fees as others for the exact same services. Our conclusion was that pensions need to be more informed regarding fees, negotiate more vigorously and carefully draft "Most Favored Nation's" provisions for inclusion in their contracts with managers. These clauses are designed to assure that the funds receive the lowest fees that the money managers have to offer.

As bad as the news is about the pension investment advisory fees, it is my perception that for mutual fund investors, it is far worse. We have actually seen mutual funds that pay up to 10 times the advisory fees that pensions pay for the same services from the

same managers. There are no good reasons for mutual funds to pay these excessive fees.

I have concluded that mutual funds pay excessive management fees simply because the fund's boards of directors fail to fulfill their fiduciary duties and do not vigorously negotiate fees with managers. And it is the Nation's mutual fund investors who are paying the price.

I recommend that the fiduciary duty of mutual fund trustees be strengthened. And in discharging their duties, I believe that fund trustees should negotiate "Most Favored Nation's" clauses in their contracts with every fund manager.

Chairman SHELBY. What do you mean by "Most Favored Nation" clauses?

Mr. SIEDLE. Most Favored Nation clause is where you, the money manager, represent to the client you are giving him your best rate for an account that size. It is your best price. Eliot Spitzer has also endorsed this proposal and called for it recently in a *Forbes* article.

Members of the fund's boards of directors who are affiliated with fund managers face conflicts of interest that may make them resist vigorous negotiations with fund managers. These conflicts would be eliminated by requiring a supermajority of independent directors on fund boards and an independent fund chairman.

The mutual fund managers will resist such negotiations to reduce fees. Excessive investment advisory fees enable fund managers to comfortably enter into revenue-sharing arrangements with brokers. Revenue sharing results in tremendous amounts of money being paid to brokers that agree to push the funds.

Mutual fund brokerage commission rates related to portfolio trading are also in excess of what they should be and are intentionally kept high by managers who want to use the excess to compensate brokers for selling fund shares.

Another practice that I wanted to discuss was that of using soft dollars to purchase goods and services. I believe that Congress should repeal the safe harbor for soft dollars. However, if soft dollars continue to be allowed, the amount of soft dollars should be disclosed and included in computing management fees, since soft-dollar amounts are, in reality, another form of manager compensation. Many pensions actually do this. They will add into a money manager's fee the cost of soft dollars.

As a result of using client commissions for marketing and research, fund investors are essentially giving huge amounts of money in commissions for the business expenses and interests of the mutual fund money managers.

Fund directors should ensure that the client funds are used to benefit the investors. I believe it is inappropriate to use fund assets to pay the ICI, the industry lobby group, because I have not seen that it has historically advocated in the best interest of mutual fund investors and, thus, investors do not benefit from the ICI receiving their money. I bring to your attention an article from *Forbes,* dated September 15, 2003, entitled, "Your Money at Work Against You," in which Neil Weinberg and Emily Lambert have stated similar views. In short, the ICI "uses the money to oppose virtually every proinvestor initiative to come out of the SEC or Congress."

Mutual fund investors are treated as second-class citizens by many money managers. Mutual fund investors are typically far less fee- and performance-sensitive than institutional accounts, and are less profitable to money managers than hedge funds.

In the mutual fund industry, "assets under management" has unfortunately come to mean "assets used by management." So, in the face of the ethical shortcomings that have surfaced, there is a stronger need for Congress to protect mutual fund investors.

The serious problems that I have mentioned have been long-standing. While some believe that the transgressions surfacing at this time were desperate measures adopted by the mutual fund industry as assets under management plummeted around 2000, I can assure you, from personal experience, that improper and unethical activity has been pervasive for over 20 years.

The effect that the problems with mutual funds have had on the Nation's retirement savers is tragic. The entire investment return attributable to an individual's retirement account over a lifetime may be eaten away by excessive fees and other malfeasance.

I believe that skimming by the mutual fund industry is a significant factor in explaining why the Nation's retirement savers will enter into retirement with lesser assets than they envisioned.

While we cannot eliminate the potential for poor investment decisionmaking, we must seek to ensure that investors have clear disclosure of the information necessary to make good investment decisions and, most importantly, are treated fairly. When the industry fails to do this itself, we must have statutes and regulations that promote this.

We want mutual fund investors to succeed. And we want as many of these investors to succeed as possible. Every success strengthens our society, and every time an investor is robbed of his hard-earned savings, our society suffers. It is time to put an end to self-dealing by the mutual fund industry and provide mutual fund investors with the protections they always thought they had.

Thank you very much.

Chairman SHELBY. Thank you, sir.

Mr. Treanor.

STATEMENT OF MARK TREANOR GENERAL COUNSEL, WACHOVIA CORPORATION ON BEHALF OF THE FINANCIAL SERVICES ROUNDTABLE

Mr. TREANOR. Thank you, Mr. Chairman.

Mr. Chairman, I am Mark Treanor of Wachovia Corporation. I am the general counsel there. Wachovia is one of the largest providers of financial services to retail, brokerage, and corporate customers in the country. We serve 12 million households and businesses primarily in the 11 East Coast States and here in Washington. Our full-service brokerage, Wachovia Securities, serves clients in 49 States, and Evergreen Investments is our asset management business, serving more than 4 million investors with a broad range of financial products.

I am a member of The Financial Services Roundtable, and I am very pleased to be here to testify on the Roundtable's behalf today.

The Roundtable would like to start off by commending you, Chairman Shelby, and this Committee for the thorough and delib-

erate examination of mutual fund issues which has been conducted to date. The Securities and Exchange Commission is also conducting a comprehensive review of mutual fund regulation. Not only is the SEC moving aggressively to consider proposals to prevent recurrences of such things as abusive late-trading and market timing, but the Agency has also proposed or already adopted rules across virtually the entire spectrum of mutual fund operations. The Roundtable believes the regulatory process should be allowed to work to a conclusion before legislative changes are enacted.

The comment periods for many of the proposals are still open, and the Roundtable expects to file comments with the SEC and has not yet taken final positions on many of these SEC proposals, and the Roundtable would be very pleased, of course, to provide the Chairman and the Committee with copies of those comment letters when they are filed.

I would like to take a few minutes on behalf of the Roundtable. I have submitted a more detailed statement, but to comment on some of the issues and the SEC positions on some of these as well.

I will start off by pointing out, as has been noted a little bit earlier, that some investors, have the time, sophistication, and inclination to investigate and evaluate mutual fund options on their own. Other investors prefer to have an intermediary help them identify their investment goals and the funds that may be appropriate to help them meet those goals. In fact, 88 percent of mutual fund shares are purchased through intermediaries.

In addition to distributing mutual funds, intermediaries may have an important role to play in servicing customers' accounts on an ongoing basis. Many investors prefer the convenience of receiving a single statement that presents all of their investments, including their investments in various mutual fund families, rather than receiving multiple statements from different financial institutions. Intermediaries may also help investors understand those statements and the performance returns of all of their mutual fund investments.

It is proper to compensate intermediaries for those services. They are done for the benefit of the investors who choose to avail themselves of them. Historically, that compensation has taken the form of an up-front charge paid by the investor, known as a front-end sales load. Today, compensation can take various forms, including 12b–1 fees, which are deducted from fund assets to pay for distribution. The SEC has the authority to regulate a fund's distribution of securities, including how the 12b–1 fees are used. Rule 12b–1 permits funds to adopt written plans for using fund assets to pay for distribution and it, in essence, allows investors to pay for distribution and related costs over time, rather than all at once up front.

Some fund advisers may also make payments to intermediaries for distribution, sometimes known as revenue-sharing payments. It is important to note that these payments are made from the assets of the adviser, as opposed to the assets of the fund. Futhermore, a broker-dealer's registered representatives always remains subject to rules that require that the funds they recommend to investors be suitable for those investors.

Payments by fund advisers to their affiliates may also compensate broker-dealers for performing routine shareholder servicing. These functions can include processing transactions, maintaining accounts, mailing prospectuses and the like. Payment of those administrative services have helped investors have the convenience of accessing multiple fund families in a single place and receiving a single statement covering their mutual fund investments.

The term "directed brokerage" refers to the use of fund brokerage commissions to facilitate the distribution of fund shares. The NASD regulates this. The rule allows a fund to consider sales of shares and the selection of brokers to execute portfolio transactions for the fund subject to best execution and provided the policy is disclosed.

The SEC expects that fund boards will consider the potential conflict of interest inherent in using fund assets to pay for distribution. The SEC has proposed alternative amendments to the rule to prohibit mutual funds from directing brokerage transactions to compensate a broker-dealer for promoting fund shares or, alternatively, seeking comment on requiring greater disclosure.

There are a number of other items like that that the SEC is looking at. For example, requiring brokers to provide customers with information about distribution-related costs at the time of the purchase of shares. Brokers would have to estimate and disclose total annual dollar amounts of asset-based sales charges, including 12b–1 fees. Additionally, the SEC is seeking comment on whether to prohibit funds from deducting certain distribution-related costs, including some 12b–1 fees from fund assets and, instead, deducting them directly from shareholder accounts.

All of this causes the Roundtable, on each of these issues, to believe that disclosure is a very crucial tool to ensure that funds serve their shareholders and that shareholders can evaluate fund performance effectively. The Roundtable supports improvements to make certain that fund disclosures are periodic, timely, robust, efficient, uniform, and easy to administer.

As I said, the Roundtable is studying the SEC's proposals carefully and will comment on them. In general, the Roundtable feels that improvement to disclosure is a better response to these issues than is a prohibition of specific business practices. We believe the SEC is moving aggressively in its rulemaking and commend them for doing so, and we commend this Committee for its thorough examination of these issues and look forward to working with the Agency and the Committee so that investors can continue to have confidence in mutual funds as an important investment vehicle.

Thank you, Mr. Chairman.

Chairman SHELBY. Would you all agree with a premise that financial integrity in the mutual fund or any financial integrity should not put a burden on anyone? In other words, if you had integrity in your system, it should not put a burden on you if you have the basic integrity in the fund.

Do you want to comment on that, sir?

Mr. SIEDLE. Yes, I would absolutely agree with that; the people who should be entrusted with the Nation's savings to manage should be people who have integrity in their blood.

Chairman SHELBY. Especially mutual funds.

Mr. SIEDLE. Yes, this is the common man's savings vehicle really.

Chairman SHELBY. Trust. Trust.

Mr. SIEDLE. Trust is critical.

Chairman SHELBY. Do any of you have problems with that?

Mr. HAAGA. Not at all. We have spent the last several months trying to restore trust.

Chairman SHELBY. But it should not have a price. Without financial integrity, you are going to destroy the industry, are you not?

Mr. HELCK. Absolutely.

Chairman SHELBY. Is that right, Mr. Treanor?

Mr. TREANOR. Yes, sir, I agree. I was going to say I do not believe that one can either regulate or legislate integrity.

Chairman SHELBY. You cannot legislate morality. You cannot do that, absolutely right. But you can regulate and put rules and laws out there that if you do violate it, you pay a price, could you not?

Mr. TREANOR. That is correct, Mr. Chairman.

Chairman SHELBY. And that does not keep people from doing it. That is like having a statute against murder, but people are going to murder some people. We hate that, but there are. And we also have a statute against robbery, but people are going to break the statutes—that does not keep us from doing it, I mean, to legislate in the field, does it?

Let me ask you all a question because I do not know. I will start with you, Mr. Treanor. Let us say I had several accounts at Wachovia, mutual funds—whatever you sell. What would I get at the end of the month or quarterly or whatever you send out? Would I get a statement showing, let us say I invested $100,000—that is a lot of money. I do not know where I would get it—but $100,000. Would I get a statement back showing what that $100,000 has done a year later? In other words, the value of the portfolio now as opposed to what and the costs associated with this? Do you see what I am getting at?

Mr. TREANOR. You get a monthly and an annual statement.

Chairman SHELBY. Would I be able to understand it?

Mr. TREANOR. I think that you will.

Chairman SHELBY. I do not know.

Mr. TREANOR. I think if you go back to actually purchasing the funds, also, Mr. Chairman, that you will find that the broker or the intermediary from whom you purchased those funds explains at the front end what is going to go into——

Chairman SHELBY. Is this explained—we had a hearing the other day on unambiguous language that the average person is not used to—the 100 million Americans or 95 million Americans, could they understand, if they spent 10, 15 minutes on it, what their $100,000 did or did not do and the costs associated with it? We are talking about disclosure. Everybody is advocating disclosure, and I like disclosure too. Would they be able to understand what you are disclosing, I guess is the question.

Mr. TREANOR. That is certainly the goal of adequate disclosure all along in the process and starting at the front end of that.

Mr. HAAGA. Mr. Chairman, the $100,000, actually, they do not have to wait a whole year. They can get it every day.

Chairman SHELBY. See, I did not know.

Mr. HAAGA. Just go up on the website, and it is there every day, and it is what the $100,000 worth now because all of our results are given net of all fees.

Chairman SHELBY. Let us say it went up because the market went up and so forth, and let us say it went up from $100,000 to $122,000—22 percent. Now, in addition to that, would it show what it cost when that person sent $100,000 to you; in other words, what are the costs to maintain it, to invest it and all of this?

Mr. HAAGA. Any up-front charges——

Chairman SHELBY. Do you understand what I am getting at?

Mr. HAAGA. Yes, sir.

Chairman SHELBY. See, I do not.

Mr. HAAGA. Any up-front charges are deducted from the amount they send us, so they would get a confirmation saying it is $98,000 or whatever the number was.

They would also get a prospectus, and on the front cover page, in clear language, in a single percentage number, they would see the annual effect of all fees, so they would know what was deducted from the outcome.

And, of course, any statement they get is going to be net of the fees, so they know what the fees are, but what they see is their actual account value throughout the life of the investment.

Chairman SHELBY. Mr. Helck.

Mr. HELCK. In addition to showing what you put in and any deductions that came out for front-end sales charges, so therefore the net amount your account was worth, the statement may also tell you what it was worth last month, at the end of last year, and give you a rate of return on how you are doing in your investment. And maybe, depending on the account services that you enlist in your account, how that might compare to other comparable indexes.

Chairman SHELBY. Explain this to me about brokerage fees. If I were a broker, I would expect to be paid for my services, otherwise I would not do them. The market does work, let us be honest with you. Why would I sell mutual funds if I were not going to get paid for it? I would not. No one would.

Mr. HELCK. Absolutely not.

Chairman SHELBY. Are those fees disclosed? And if they are not disclosed, why are they not disclosed?

Mr. HELCK. The fees are disclosed.

Chairman SHELBY. I know, but we have been hearing for sometime that they need more disclosure on brokerage fees.

Mr. HELCK. The fees that are disclosed are the sales charges that paid the person who is selling you the funds, and they have several different models that they can offer you, and they are obligated, by regulation, to explain those choices to you, to include also a fee-based account which may not have any commissions at all, but have an advisory fee.

Chairman SHELBY. Well, I certainly do not believe we should legislate or regulate what fees are, that the market should set fees, but it seems to me that it would behoove the mutual fund industry that you had an informed purchaser or shareholder, that it would be in your long-term interest, especially if you were a well-managed fund. If you were not, you might not want to disclose anything. You might want to get out of town.

Mr. HELCK. And to a good point. If you do not disclose it, your competition clearly will disclose to your client what you paid or should have paid or could have paid, and if they feel like you have abused their trust, then they are very quick to move to another source of their services.

Chairman SHELBY. This morning—a lot of you heard or aware of the hearing this morning—we held a hearing that examined soft-dollar practices. The witnesses, among other things, discussed the merits of various reform alternatives. We will start with you, Mr. Haaga. Would you comment specifically on should Congress repeal Section 28(e)? And if not, why not? And should the SEC require firms to unbundle commissions? And what should be done to revise the definition of "research" as a broad term?

Mr. HAAGA. We strongly recommended the SEC tighten the definition of "research" so it includes only intellectual content and does not include the Bloomberg machines that Senator Fitzgerald described. So we are clearly in line with his recommendation on that.

We have also suggested that third-party research, where there was actually a portion of the commission that is paid to someone else, and therefore it is identifiable, and it is clear that these products are commercially obtainable for a cash price, that those be eliminated from the 28(e).

Chairman SHELBY. Personally, if I was investing in a mutual fund, and if you were well managing and you made my fund grow, I would not mind paying a little research or whatever it was. That is just common sense.

Mr. HAAGA. I think the question is not whether they should pay it, it is how they should pay it, and we think the advisory fees——

Chairman SHELBY. And how it should be disclosed——

Mr. HAAGA. Exactly, sir.

Chairman SHELBY. —with a definition.

Mr. HAAGA. We think the advisory pays for that.

As far as repealing 28(e), you would have to take an initial step, and it is one that the United Kingdom regulator is struggling with now, and that is, in order to repeal the safe harbor for proprietary research—that is the research that is given to you by——

Chairman SHELBY. Can the Commission deal with it without statutory——

Mr. HAAGA. The SEC can do the things we have recommended without statutory approval.

Chairman SHELBY. If they have the will.

Mr. HAAGA. Correct.

Chairman SHELBY. For many years, you have worked at this. So you know.

Mr. HAAGA. Yes. The SEC can do everything that we have recommended that they do, tightening the definition and eliminating third party on their own.

Chairman SHELBY. We are going to find out what they are going to do.

Mr. PUTNAM. Mr. Chairman, could I add, also——

Chairman SHELBY. Yes, sir.

Mr. PUTNAM. —from a small fund's perspective, the total elimination of 28(e) would be very harmful I think to many small funds who do not have access to——

Chairman SHELBY. Yes, that was made this morning.

Mr. PUTNAM. —to research, to intellectual property, and they depend on soft dollars to access intellectual property, and I think that is appropriate because that is in the best interests of long-term shareholders.

Chairman SHELBY. Would it bring about unfair competition, in a sense?

Mr. PUTNAM. Pardon me?

Chairman SHELBY. Would it bring unfair competition for the big versus the small in the mutual funds?

Mr. PUTNAM. Well, that is one of the ways actually to bring more competition and enable smaller funds to participate in that arena.

Mr. HELCK. No matter how large the organization, nobody has the resources to cover every company as thoroughly as they need to be covered. So having outside research resources is in all of our interests, and the more competition there is, the better it serves our industry.

Chairman SHELBY. Yes, sir. Go ahead.

Mr. SIEDLE. The remarkable thing about money managers is when you ask them do they do their own research or do they rely on the information of others, uniformly, money managers say they do their own research.

The Nelson's Guide to money managers asked managers to indicate how much they rely on Street research and how much do they use their own research. We asked Nelson's to do an analysis to indicate how much managers claim to do their own research.

Managers claim to do 80 percent of their own research. A good money manager does his own research and does not rely heavily on research done by others, and that is one of the selling points of their services.

Mr. HAAGA. Can I respond to that?

Chairman SHELBY. Yes, sir. Go ahead.

Mr. HAAGA. We do our own research at Capital. We are famous for it. We have several hundred research analysts all over the globe, but we also read the Street research to see what other people are saying. So he is positing it as an either/or. It is not an either/or. We look at every resource possible.

Mr. PUTNAM. Mr. Chairman, could I also add to that?

Chairman SHELBY. Yes, sir, go ahead, and then I am going to call on Mr. Treanor.

Mr. PUTNAM. We are an internal research house. And while I talked to the issue of soft dollars, we do not use any soft dollars.

There are several small-fund groups that are very good groups who do their own internal research. One of the small-fund groups was before this Committee February 26—Mellody Hobson, from Ariel Group, and they do a great job too. We know several of those groups that do internal research. But I do think soft dollars provide some flexibility for smaller fund groups who do not have access to the full range of research that we perhaps look at.

Chairman SHELBY. Mr. Treanor, go ahead.

Mr. TREANOR. Mr. Chairman, what I was going to say is just three brief points.

First, I think this discussion points out that, in many respects, one size does not fit all. There is a great deal of variety in the industry.

Second, there has been an SEC study that looked at the use of soft dollars over the last several years, and it concluded that there were very few instances of abuse of soft dollars, that they were actually well-used to help investors themselves.

Third, I think that the Chairman hit the nail on the head with the idea that this is again a disclosure issue, when you do not have something that is uniform across the industry, and it will be something that will differentiate funds.

Chairman SHELBY. Mr. Haaga, many people contend that your proposal to eliminate soft-dollar payments for third-party research provides a regulatory advantage for full-service brokerage firms. Why did you not also propose to ban the use of soft dollars for proprietary research that is produced by full-service broker-dealers?

Mr. HAAGA. Let me say, if there were proprietary research that had a cash price on it, then it would follow logically that it should be banned as well because that should be paid for by the adviser.

The challenge here is that there really is, if you look at 28(e), it defines the term "brokerage and research services." It does not separate out the two. And in the United Kingdom, they have been working for the past several years trying to unscramble that egg and say when brokerage ends and research begins, and they are having a terrible time of it.

I think if you wanted to do that, if you wanted to eliminate proprietary research, you would have to first define where the brokerage ends and the research begins, and then make them unbundle it and pay for it, and that is the challenge. That may be a later step, but we certainly did not want to hold up the very good step and the very straightforward and easy step of eliminating the third-party research payments. Of course, the important part of that is also the directed brokerage for sales.

Chairman SHELBY. I am going to direct this question to Mr. Treanor and Mr. Helck.

How would a requirement that broker-dealers must unbundle commissions and assign specific values for research and execution impact commission cost? Would commissions decrease? Would it impact the availability of independent research?

Do you want to try that, anybody? Do you want me to ask that again?

Mr. HELCK. I think that I understand the thrust of your question.

Chairman SHELBY. You understand the question.

Mr. HELCK. I believe that it would result in less research being available.

Chairman SHELBY. Why?

Mr. HELCK. Because it would seek to allocate artificially the costs or the value of research and execution.

Chairman SHELBY. Why do you use the term "artificially" here?

Mr. HELCK. As I thought Mr. Haaga said so artfully, it is unscrambling an egg, and nobody knows how to do it. And so you have to make an arbitrary decision and make some assignments. The problem with that is that execution is so nonuniform. Different

trades, different liquidity, different days of the week, and different requirements of the portfolio put different values on the trade. And so if we artificially say *x* percent goes to this and that, it is not real. Therefore, in some cases it will be over, in some cases undervalued, and I am not sure that improves anything unless we figure out a way to do it that is just and appropriate.

Chairman SHELBY. It is not exactly in the math, is it, not totally?

Mr. HELCK. If it results in firms saying, I cannot be in this business because I cannot execute appropriately, and therefore they withdraw coverage on companies, therefore there is less coverage and less research available, that would be bad for investors.

Chairman SHELBY. Mr. Treanor.

Mr. TREANOR. I think the only thing that I would add to that is, again, this is one of the issues I think that the Roundtable is taking a look at across the industry because it would have a different impact on different firms and the way that they would be able to handle that going forward.

Chairman SHELBY. You all are very familiar with what has been going on in the Banking Committee, and you are probably familiar with Bob Posen's testimony here. He proposed a method for providing investors individualized cost disclosure in their quarterly statements. Mr. Posen indicated that an individualize estimate could be done without great cost or administrative burdens to the funds.

Would each of you address his comment on the utility of providing investors an individual cost figure. Also, should investors receive both an individual cost figure and an expense number that they can use to compare funds? In other words, they are in the marketplace.

Mr. Haaga, do you want to start.

Mr. HAAGA. Yes, I think the important word in Mr. Posen's phrase was "estimate." It is an estimated phrase, and of course since they can do their own estimate when we give them the percentage, when we give them the amount per thousand dollars, they just multiply by the thousand they have, so they can come up with that estimate.

I think that the most relevant aspect of expenses is how they look comparatively. There is no relevance to them unless you can compare them to what you would use for another fund.

Chairman SHELBY. But if they have something to compare with, they could compare, could they not?

Mr. HAAGA. That is why we support the SEC's proposal versus the GAO proposal, which would give a standardized fee disclosure. And I think one disclosure is enough. Adding something else that says, and here is what the math would be if you applied it to your own fund, I do not think is necessary. I think it is better to stick with the one number—this is the per thousand—because that is the one they can compare.

Chairman SHELBY. Mr. Helck.

Mr. HELCK. Keeping in mind that your condition on that question was that it was cost-effective, we, as I said earlier, have over 11,000 CUSIP's, that means different mutual fund classes, that we propose. It is hard enough, we need only consult the break-point issue to see how complex it is for broker-dealers to be informed by

the funds of all of the various discount criteria for administering that program, which is overwhelming, and those are relatively stable. Once stated in the prospectus, they tend to stay the same for a long period of time, but these expense numbers change daily, quarterly, annually.

And so it is a process of having to have good sources of information on a flowing, dynamic basis that can recalculate against every fund, and every shareholder, and every account value and get recalculated, and how you can do that in a cost-effective way eludes any of us who have given it consideration, which is why we say let us come up with something that is cost-effective, that will not unduly burden the cost of the funds and the shareholders and does represent to them what their experience would be on a reflective basis.

Chairman SHELBY. Mr. Putnam.

Mr. PUTNAM. I might anecdotally add we have our own shareholder services firm and also transfer agency, and I talked to the person that heads that up and said, "Could we be able to do this?"

And he looked at me and he said, "Well, you know, I do not know how we are going to be able to do it at this point. I do not know of any software that is available to do that, especially for small funds." And the 60-cent-per-statement cost I heard earlier was shocking to me.

But, at any rate, I think fee disclosure is important when it is in the best long-term interests of shareholders. And the only way that I think that is possible is to make it in a form that they could compare it to other funds. And I think the expense ratio does this pretty adequately. I mean, if you think about gasoline, when you compare gasoline, you do not compare the total costs that you are putting in your tank. You compare the price per gallon. And I think expense ratios do that.

But I also would like to add that I think the emphasis on looking at fees only as being part of the solution to how investors think about buying a fund is one that only looks at a very small minority piece of that decision.

If I may, for just a minute, I would like to just read this from my—this happens to be our shareholder letter that is going out with our statements at the end of March.

Chairman SHELBY. Yes, sir. Take your time.

Mr. PUTNAM. This is a paragraph from that shareholder letter that I wrote:

> We agree with several new proposals designed to ensure that shareholders fully understand the expenses of mutual fund ownership. In fact, we are taking an extra step to prepare an owner's manual, which we hope will help our shareholders understand all fees and expenses associated with an investment in FAM Funds.
>
> However, we believe that a shareholder's decision to invest in a mutual fund should not be based solely on numbers, whether they are related to expenses or performance, but also on a system of shared beliefs about investing. The alignment of fund managers and shareholders should be forged in terms of shared interests, similar beliefs in terms of investment objectives, risk tolerance, and service levels.
>
> While performance and expenses can be quantified, the inclusion of these other components combine both the art and science of investing and create an understanding that goes beyond mere numbers.

So I think there is more to the discussion as to what is in the best interests of long-term shareholders than just looking at fees as being part of the equation.

Chairman SHELBY. Putting in information that they can understand as to cost, long-term and short-term interest to them.

Mr. PUTNAM. That is correct.

Chairman SHELBY. Mr. Siedle.

Mr. SIEDLE. I do not think most investors have a system of shared beliefs about investing. I do not know if you do. I do not know that I do. Most investors, their belief about investing is that they are going to put their money away somewhere and hope that it grows, and that is about it. And the fact is that one of the most objective criteria an investor can look at is cost and fees. And as we heard earlier, the lowest cost funds, in fact, generally outperform the higher cost funds.

So fee information is terribly important, and the only other information investors typically rely on is past performance, and we all know how fallible that is. So, I think enhancing fee information is critical and giving information about the cost of index funds versus actively managed funds is also critical.

One last point I want to make is I have owned brokerage firms for 14 years, and I can tell you to a penny what it costs to execute a trade. I do not know what this difficulty in calculating it is. In fact, firms like mine that clear through Merrill Lynch, we are given a statement on every trade of what the cost of execution is. It is 15 percent of the commission. The rest is fluff. It is commission. It goes in my pocket.

Chairman SHELBY. Mr. Treanor.

Mr. TREANOR. I think the key on that issue is that disclosure of the fees to investors is extremely important and that it needs to be done in a fashion which will allow them to compare fund-to-fund so that they can make the appropriate investment decisions, and that is probably done in the best fashion by using the SEC proposal on that instead of the individualized account that otherwise would be proposed.

Chairman SHELBY. Should funds be required to deliver to investors a summary prospectus with material cost and expense information at or before the time of their purchase?

Mr. HAAGA. Well, summary prospectus. We supported very much the Arthur Levitt effort back in the late 1980's, early 1990's, to develop the summary prospectus.

We also support the proposal to have point-of-sale disclosure of fees. The actual proposal now is not a full summary prospectus, but it is a statement of fees, and we think that both those proposals are a good idea.

Chairman SHELBY. Do you have any comments, Mr. Helck?

Mr. HELCK. We are all in favor of full disclosure. It is the method of how we do it that we want to talk about it.

Chairman SHELBY. But the method is important, is it not, the method of disclosure?

Mr. SIEDLE. I think a summary prospectus would be a fine idea.

Chairman SHELBY. The SEC is considering, as you all know, a rule change that would clarify the use of 12b–1 fees by stating that the fees can only be used for advertising and distribution payments and must be deducted directly from the shareholder's account rather than fund assets.

What is your view on the use of 12b–1 fees and the merits of the SEC's potential proposal?

We will start over here on the left.

Mr. HAAGA. I think it would be a mistake to repeal 12b–1, which is I think the proposal as you summarized it, and to require that all ongoing payments be made by the shareholder.

I would go back to 1988, when we adopted our 12b–1 plans, and we decided that 25 basis points—we, American Funds—was the right amount of ongoing service fees to pay brokers, and set that, and that has been the rate, and it has never changed since.

And I have a hard time believing that if we quit dictating it—we, the provider of the fund or manager of the funds—quit dictating what that 12b–1 fee is going to be and turn it over to the brokers, I cannot imagine it is going to go down. I would suggest that it may even go up.

In addition, we have an incentive to keep the fees low and that is that all of our investment results are reported net of that fee. If the fee is shifted over to the shareholder, we will report investment results that are not net of that fee, and we will have less of an incentive to keep it low. So, I think we should keep the fee in the fund in the form of the 12b–1.

Chairman SHELBY. Should funds be permitted to charge 12b–1 fees after a fund has already closed?

Mr. HAAGA. Well, I deal with a lot of people who are retired. We have a lot of friends who are retired, and they are never going to buy another fund share in their life. Their goal now is not to outlive their savings. And every time the market moves, and every quarter, whether it does not, they go visit their broker, and they talk to them about how much money they can take out, get them to do the recalculations, talk about, assure them that they are not going to outlive their money.

If one of their funds that they are invested in stops selling fund shares, they do not stop owning them. They still go visit their broker, and somebody needs to pay that broker. So the idea that for some reason the service fees should be stopped on all of those retirees that are going and seeing their brokers just perplexes me. It is the wrong view of what a 12b–1 fee is for.

Chairman SHELBY. Does anybody have any different—yes, sir, Mr. Siedle.

Mr. SIEDLE. But there are a lot of other fees that mutual fund companies pay brokers to keep clients in their funds—their commissions, directed commissions, which are substantial, their revenue-sharing arrangements. And so 12b–1 fees are not the sole source of compensation to brokers.

Chairman SHELBY. How about after the fund is closed?

Mr. SIEDLE. After the funds close, it still trades. Commissions are being directed to brokers out there.

Mr. HAAGA. We propose to eliminate directed brokerage commissions.

Mr. SIEDLE. I think that would be an excellent idea.

Mr. HELCK. The assumption of that proposal is that the basic value provided by the financial adviser is the transaction when they buy it. And what we are trying to point out is it is the ongoing

service, advice, due diligence, and counsel that is provided that is being compensated for, and it is appropriate that it should be.

Chairman SHELBY. Getting into a little different area now. I appreciate your patience. These are important questions for the record here we think.

The Committee is considering reforms that would help ensure that funds are subject to competitive market forces. We all agree with that. People make choices in the market.

In light of this objective—and I hope it is yours—would each of you discuss Section 22(d) of the Investment Company Act in this regard, which essentially requires funds to fix sales load in the prospectus. In other words, why should sales loads be fixed in the prospectus rather than allowing funds and broker-dealers to compete with one another on price?

Mr. SIEDLE. Section 22(d) I think is, in order to establish fairness——

Chairman SHELBY. That is right.

Mr. SIEDLE. —that brokers are not cutting deals with everybody under the sun, and therefore you will never know that you are paying the same price as someone else. I think the statutory provision makes sense, and I think it should stay.

Mr. HELCK. Actually, that has served well, if you look back over the history of funds. But there is an emerging alternative to that, that the marketplace has created in fee-based accounts, where essentially there is no sales charge added to the fund share price, but a fee is paid directly by the client for advisory services, and that choice exists as well. So the marketplace can choose how it wants to be served.

Chairman SHELBY. And what is generally that advisory fee?

Mr. HELCK. That is negotiated based on the level of service that is expected from the client.

Chairman SHELBY. It depends on the quality of the advice, I would hope.

Mr. HELCK. Exactly right, and the amount of service that the client expects.

Chairman SHELBY. In a recent press report in *The Washington Post,* it was said that some fund managers “have engaged in the practice of window dressing, a practice through which funds seek to improve their portfolios by selling more speculative investments and buying more conservative ones right before they disclose their holdings to investors twice a year.”

Is window dressing another widespread industry practice that investors do not know about? What other practices are out there that we should know about as we near the conclusion here?

Mr. HAAGA. I am certainly not aware of any window dressing practices, widespread or otherwise. It would be pretty easy for the SEC to finally go in and do an inspection and say, “Give me all of your trades for the last 3 days of the period.”

I also would point out that the investment results do not stop at the end of every quarter. We have to disclose those over 1-, 5-, and 10-year periods, and you cannot——

Chairman SHELBY. Most people in mutual funds are in it for the long haul.

Mr. HAAGA. Right. You can dress up your portfolio, but you cannot dress up your results. I wonder what the incentives are, but——

Chairman SHELBY. If you are playing games with your fund, you are playing games on yourself, too, are you not?

Mr. HELCK. And the cost of doing those transactions comes out of your results, so it is counterproductive unless it does you some good.

Chairman SHELBY. Mr. Putnam, do you have any comment on window dressing?

Mr. PUTNAM. No, I agree with everything that was just said.

Chairman SHELBY. Mr. Siedle.

Mr. SIEDLE. I think there are a lot of abuses that have still not surfaced that will surface in time. Front-running by portfolio managers——

Chairman SHELBY. Tell us what you mean by "front-running."

Mr. SIEDLE. Front-running is, if I am running a portfolio, and I know I am going to buy a million shares of Dell stock today or tomorrow, I will buy it for myself today, knowing that when I buy it tomorrow, it will go up in price, and I will have made an immediate profit.

Front-running is something I have investigated, and it does happen at mutual fund companies.

Chairman SHELBY. Does it happen everywhere there is a lot of money being traded?

Mr. SIEDLE. As long as there are human beings involved, yes. As long as there is temptation, there is always going to be somebody who succumbs to it. There are other practices like parking. Funds that have affiliated investment banking arms will park client stock in the mutual fund portfolios. Another thing is what is called pump-priming, which is where you start a fund out with like $100,000 and trade a bunch of stock and show a great performance record, and then you advertise it, and then of course it goes down immediately as money starts rolling in.

Mr. HAAGA. Each of the things that Mr. Siedle just described is illegal. So do not worry that we need any more rules.

Mr. SIEDLE. No, we need enforcement.

Chairman SHELBY. Enforcement. If it is illegal, we do need enforcement.

Mr. Treanor, you have a comment?

Mr. TREANOR. That is exactly the point I was going to make is that I do not know that any of those are major problems in the industry, and they are all covered by laws and regulations today.

Chairman SHELBY. But you are not suggesting there is not trouble in the industry or has not been.

Mr. TREANOR. No, I am not suggesting that at all. There certainly has been. I do believe firmly, though, Senator, that the overwhelming majority of people in the industry get up every morning and try to do the right thing.

Chairman SHELBY. I do not doubt that.

I appreciate the panel being here today. It is going to be interesting when we have the SEC at our final hearing. I know you will be watching that. We will probably have a big attendance that day.

Thank you very much.

The hearing is adjourned.

[Whereupon, at 4:32 p.m., the hearing was adjourned.]

[Prepared statements and additional material supplied for the record follow:]

PREPARED STATEMENT OF PETER G. FITZGERALD

A U.S. SENATOR FROM THE STATE OF ILLINOIS

MARCH 31, 2004

Good afternoon, Chairman Shelby, Ranking Member Sarbanes, and Members of this distinguished Committee. Thank you for including me as a witness today during your hearing on mutual fund fees. I would like to commend you and the Banking Committee for the series of in-depth hearings you are holding on the mutual fund industry.

Today, I would like to discuss S. 2059, the Mutual Fund Reform Act of 2004, that I introduced on February 10, 2004. I was pleased to be joined in introducing this legislation by my distinguished colleagues on the Committee on Governmental Affairs, Senator Carl Levin and Senator Susan Collins, the Committee's Chairman, from whom you also will hear today. I am grateful for the extensive and important input both Senators provided in the drafting of this bill, and appreciate the invaluable perspective Senator Collins provided based on her first-hand experience as Maine's Commissioner of Professional and Financial Regulation.

Since we introduced MFRA, we have been joined by a solidly, bipartisan group of Senators who are cosponsors. We welcome the support of Senators Lugar, Voinovoich, Hollings, Lautenberg, Durbin, and Kennedy.

The Mutual Fund Reform Act, referred to as MFRA, would make fund governance truly accountable, require genuinely transparent total fund costs, enhance comprehension and comparison of fund fees, confront trading abuses, create a culture of compliance, eliminate hidden transactions that mislead investors and drive up costs, and save billions of dollars for the 91 million Americans who invest in mutual funds. Above all, MFRA strives to preserve the attraction of mutual funds as a flexible and investor-friendly vehicle for long-term, diversified investment.

I would like to take this opportunity to recognize the work of a number of our colleagues in this area. Last year, I was pleased to cosponsor S. 1822, introduced by Senator Daniel Akaka, the Ranking Member of the Senate Governmental Affairs Subcommittee on Financial Management, the Budget, and International Security, which I chair, to address mutual fund trading abuses. Senators Corzine, Dodd, and Kerry also have sponsored mutual fund bills from which I drew, as well as legislation introduced by Congressman Richard Baker last summer and overwhelmingly passed by the House of Representatives at the end of the last session.

Mr. Chairman, MFRA reflects extensive testimony that was presented during oversight hearings of the Financial Management Subcommittee that I chaired on November 3, 2003 and January 27, 2004. The general consensus of the panelists at the November hearing was that illegal late trading and illicit market timing were indeed very serious threats to investors but that excessive fees and inadequate disclosure of those fees posed a much more serious threat to American investors. Witnesses at our hearing in January testified regarding the propriety and the adequacy of the disclosure of mutual fund fees, specifically hidden costs such as revenue sharing, directed brokerage, soft-money arrangements, and hidden loads such as 12b–1 fees. The Subcommittee also heard from two whistleblowers who were responsible for the initial revelations regarding Putnam Investments and Canary Capital Partners, LLC.

MFRA also reflects the constructive input from a number of key organizations and leaders of mutual fund reform. I especially appreciate the extensive contributions of John Bogle, the Founder and former CEO of the Vanguard Group, who has been a champion of reforms in the mutual fund industry for many years. In his letter of endorsement of February 6, 2004, Mr. Bogle indicated that he viewed MFRA "as the gold standard in putting mutual fund shareholders back in the driver's seat."

In addition to Mr. Bogle, the following individuals and organizations have endorsed MFRA: Massachusetts Secretary of State William Galvin, the Coalition of Mutual Fund Investors, Fund Democracy, Consumer Federation of America, U.S. Public Interest Group, Consumer Action, Consumers Union, and the Government Accountability Project.

I ask consent from the Committee that letters of endorsement from these leading individuals and organizations be made a part of the record following my statement.

As Members of this Committee know well, in 1980 only a small percentage of Americans invested in mutual funds and the assets of the industry were only $115 billion. Today, roughly 91 million Americans own shares in mutual funds and the assets of all the funds combined are now more than $7 trillion. Mutual funds have grown in popularity in part because Congress has sanctioned or expanded a variety of tax-sheltered savings vehicles such as 401(k)'s, Keoghs, traditional IRA's, Roth IRA's, Rollover IRA's, and college savings plans. Given that mutual funds are now

the repository of such a large share of so many Americans' savings, few issues we confront are as important as protecting the money invested in mutual funds.

Overview of the Mutual Fund Reform Act of 2004

The Mutual Fund Reform Act of 2004 puts the interests of investors first by:

- Ensuring independent and empowered boards of directors;
- Clarifying and making specific fund directors' foremost fiduciary duty to shareholders;
- Strengthening the fund advisers' fiduciary duty regarding negotiating fees and providing fund information; and
- Instituting Sarbanes-Oxley-style provisions for independent accounting and auditing, codes of ethics, chief compliance officers, compliance certifications, and whistleblower protections.

The Mutual Fund Reform Act of 2004 empowers both investors and free markets with clear, comprehensible fund transaction information by:

- Standardizing the computation and disclosure of (i) fund expenses and (ii) transaction costs, which yield a total investment cost ratio, and tell investors actual dollar costs;
- Providing disclosure and definitions of all types of costs and requiring that the SEC approve imposition of any new types of costs;
- Disclosing portfolio managers' compensation and stake in the fund;
- Disclosing broker compensation at the point of sale;
- Disclosing and explaining portfolio turnover ratios to investors; and
- Disclosing proxy voting policies and records.

The Mutual Fund Reform Act of 2004 vastly simplifies the disclosure regime by:

- Eliminating asset-based distribution fees (Rule 12b–1 fees), the original purpose of which has been lost and the current use of which is confusing and misleading—and amending the Investment Company Act of 1940 to permit the use of the adviser's fee for distribution expenses, which locates the incentive to keep distribution expenses reasonable exactly where it belongs—with the fund adviser;
- Prohibiting shadow transactions—such as revenue sharing, directed brokerage, and soft-dollar arrangements—that are riddled with conflicts of interest, serve no reasonable business purpose, and drive up costs;
- "Unbundling" commissions, such that research and other services, heretofore covered by hidden soft-dollar arrangements, will be the subject of separate negotiation and a freer and fairer market;
- Requiring enforceable market timing policies and mandatory redemption fees—as well as provision by omnibus account intermediaries of basic customer information to funds to enable the funds to enforce their market timing, redemption fee, and breakpoint discount policies; and
- Requiring fair value pricing and strengthening late trading rules.

The Mutual Fund Reform Act also would perpetuate the dialogue and preserve the wisdom gathered from hard experience. MFRA directs the SEC and the General Accounting Office to conduct several studies, including a study of ways to minimize conflicts of interest and incentivize internal management of mutual funds; a study on coordination of enforcement efforts between SEC headquarters, SEC regional offices, and State regulatory and law enforcement entities; and a study to enhance the role of the Internet in educating investors and providing timely information about laws, regulations, enforcement proceedings, and individual funds, possibly by mandating disclosures on websites.

The Essential Role for Congress in Putting America's Investors First

Mr. Chairman, some people now inquire whether this institution has any role to play in cleaning up an industry that controls so much of America's savings. I believe it would be a serious mistake if we fail to enact meaningful reform legislation. This is an historic opportunity to do right by 91 million Americans who trusted too well.

I certainly commend the many recent regulatory initiatives from the Securities and Exchange Commission. They are collectively a step in the right direction and a demonstration of our seriousness in Washington about putting the interests of America's mutual investors first. But the SEC does not have the statutory authority to take all of the needed steps to restore integrity and health to the mutual fund industry. The current scandals demand that Congress take a comprehensive look at an industry still governed by a 64-year-old law.

For example, the SEC cannot tighten the definition of what constitutes an "independent director." The definition of "interested"—in contrast to "independent"—appears in the 1940 Act, and the SEC is normally not empowered to make law around

acts of Congress. (I say “normally” because the SEC *has in fact done precisely that* in several areas, through its so-called “exemptive rules,” which I will discuss in a moment.)

As we aim to empower a truly independent board of directors to act as the “watchdogs” for investor interests that they were intended to be, it is critical we tighten the statutory definition of what constitutes “independence.” The SEC itself has made this point persuasively in testimony before the House Financial Services Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises. Mr. Paul Roye, Director of Investment Management at the SEC, testified before that Subcommittee on June 18, 2003 about H.R. 2420, the bill that ultimately overwhelmingly passed the House, as follows:

> Finally, Section 4 of the bill would amend Section 2(a)(19) of the Investment Company Act to give the Commission rulemaking authority to deem certain persons to be interested persons as a result of certain material business or close familial relationships. We strongly support this amendment, which would permit us to close “gaps” in the Investment Company Act that have permitted persons to serve as independent directors who do not appear to be sufficiently independent of fund management. For example, currently a fund manager’s uncle is permitted to serve on the fund’s board as an independent director. In other cases, former executives of fund management companies have served as independent directors. Best practices guidelines of the Advisory Group provided that former fund management executives should not serve as independent directors because their prior service may affect their independence, both in fact and in appearance.

I could not have said it better than the SEC itself has testified about the need for Congress to step up to the plate—even if the SEC remains absolutely committed to doing what it can to clean up the industry.

Mr. Chairman, I will give you a few more examples of what the SEC cannot do. Of the various nefarious transactions that have become commonplace in the industry, few match soft-dollar arrangements for sheer anticompetitive and anti-investor brazenness. With soft-dollar arrangements, investment advisers essentially get to finance their office overhead with investors’ money—and that is on top of the substantial adviser’s fee they collect, also from investors’ money. Investment advisers cause investors to pay an artificially inflated commission on every transaction in the fund’s portfolio—and investment advisers thereby obtain “soft-dollar credits,” which they can use for research, computer terminals, and other office overhead. In Section 28(e) of the Securities Exchange Act, Congress permits soft-dollar arrangements. MFRA prohibits soft-dollar arrangements—and only Congress can do that. Through rulemaking, the SEC can interpret the “safe harbor” in Section 28(e) narrowly or broadly—and it has done both—but it cannot eliminate the safe harbor. It is time for Congress to correct the error of that safe harbor.

As for the SEC view, I am pleased to quote again from Mr. Roye’s testimony on June 18, 2003:

> Our current regulatory regime primarily relies on disclosure by advisers of their soft-dollar policies and practices. The staff responses submitted last week suggested that disclosure alone might not be adequate and suggested the need for Congressional reconsideration of Section 28(e).

Congress should act to eliminate this indefensible and anticompetitive confiscation of shareholder money.

Further, Congress must act to strengthen and clarify what it truly means to be a fiduciary in the mutual fund industry. A “fiduciary duty” is supposed to entail much more than mere honesty and good faith, but it has too often meant much less. The Investment Company Act of 1940 refers to the fiduciary duty of both fund directors and fund advisers—but in both cases, the duty has been relatively empty and virtually unenforced. Indeed, the investment adviser’s fiduciary duty with respect to fees is so weak—as interpreted by Federal courts—that I am advised that not a single plaintiff has ever prevailed in an excessive fees case. MFRA amends the Investment Company Act to strengthen these twin fiduciary duties of directors and advisers to make abundantly clear that the interests of investors are always paramount. In the case of advisers, MFRA makes clear that their fiduciary duty extends not only to fair fees, but to providing all material information to directors in the directors’ exercise of their fiduciary duties—a statutory and regulatory lapse that has made it very difficult for good-faith directors to wrangle essential information out of advisers.

A level playing field is critical to the proper resolution of market forces. Arm’s-length negotiations over fees are supposed to be the key market dynamic that keeps

State and Federal regulators out of the board rooms. But both directors and advisers need a clearer and more specific statement of their fiduciary duties, and MFRA provides it.

For a final example, MFRA shifts the fund distribution dynamic from its current anti-investor and anticompetitive posture to a fairer and more rational market-based dynamic—a change that only Congress can make. MFRA directs the SEC to repeal its Rule 12b–1—but simultaneously makes it clear that distribution expenses may be incurred by fund advisers, and thereby (1) gets funds out of the distribution business; and (2) imposes the incentive to keep distribution expenses reasonable exactly where it belongs—with the investment adviser.

The SEC cannot amend the 1940 Act to prohibit asset-based fees for distribution of fund shares. The SEC cannot amend the 1940 Act to make it clear that distribution expenses may be incurred out of the management fee paid to investment advisers. These fundamental changes embodied in MFRA would rationalize a system that has become a mockery of the 1940 Act's preamble declaration that the interests of investors are always paramount. Consider carefully what happens as a consequence of the SEC's Rule 12b–1. While funds themselves have some incentive to "grow" (primarily, for example, to ensure sufficient liquidity to meet redemptions), the overwhelmingly more powerful incentive to swell net assets is with the fund adviser, whose fee is a percentage of those assets. The current incentive and fee structure is accordingly troublesome: Individual investors typically gain nothing from growth, except in the very unusual circumstance of sustained net redemptions, in which portfolio holdings must be sold disadvantageously to meet redemptions. Yet, the industry forces these very investors to pay for promotion and growth. And it gets worse. Investors pay for promotion and growth that do not directly benefit them (and may often actually hurt them if the fund grows so large as to make strategic portfolio transactions unwieldy or impossible)—and they pay a fixed percentage for the "privilege" of doing so, regardless of fund size (*that is,* Rule 12b–1—in conspicuous contrast to its founding theoretical framework—has been almost entirely impervious to economies of scale).

Free market principles would typically discipline excessive distribution costs as a direct bite out of profits—but fund advisers are (1) collecting their substantial fees as a percentage of fund assets; *and* (b) financing the sustained swelling of those same assets with investors' money. Put another way, the King compels the cook to buy the food that fattens the King. Does the King worry about his food budget? Unlikely. MFRA rearranges this incentive structure—without dictating any specific diet. Fund advisers will now bear distribution expenses—and if, as appears virtually self-evident, some of these expenses are excessive, we can be certain that fund advisers, spending their own money, will discover the cost discipline that has been elusive to date.

Only Congress can rationalize the fund distribution system that its own Act of 64 years ago created—and that the SEC complicated with its well-intended but injuriously perpetuated Rule 12b–1.

Finally, Mr. Chairman, I would like to say a word about the SEC's so-called "exemptive rules." I am struck, given our system of separation of powers, that the SEC has managed, for example, to require a majority of independent directors on mutual fund boards, when Congress said quite clearly in the 1940 Act that only 40 percent of the directors need be independent. You won't learn about that kind of power in any basic civics textbook, because it seems to run directly counter to what the framers established. I happen to believe the SEC is right on the merits about independent directors—but I am concerned that Congress appears to have abdicated its essential legislative power to an unelected agency of the executive branch.

The SEC accomplishes this legislative function through "exemptive rules"—rules that essentially create carrots for funds, and then oblige the funds to abide by certain additional rules of they wish to take advantage of the carrots. Perhaps the best known example of an exemptive rule is Rule 12b–1—which allows funds to pay for distribution expenses *if* they comply with certain fund governance rules.[1] Apart from the separation of powers concerns triggered by reliance on such exemptive rules, I believe the system has spiraled into unacceptable complexity. Congress

[1] Other examples include Rule 10f–3 (permitting the purchase of securities in a primary offering where a fund affiliate is a member of the underwriting syndicate); Rule 15a–4 (permitting the approval of interim advisory contracts without shareholder approval); Rule 17a–7 (permitting securities transactions between a fund and certain affiliated persons of the fund); Rule 17a–8 (permitting mergers of certain affiliated funds); Rule 17d–1(d)(7) (permitting funds to purchase joint liability insurance policies with affiliates); Rule 17e–1 (addressing when funds may pay commissions to affiliated brokers); Rule 17g–1(j) (permitting joint insured bonds); Rule 18f–3 (permitting funds to issue multiple classes of shares); and Rule 23c–3 (permitting closed-end funds to repurchase shares periodically from investors and thereby operate as interval funds).

should make the essential policy determinations that have driven the SEC's exemptive rules. And Congress should make those policy directives independently binding—*not* dependent upon use of an agency-conferred benefit. It is one obvious weakness of reliance on exemptive rules that funds *may*—though it is rare for obvious reasons—opt out of the agency-conferred benefit, and thus decline to be bound by the requirements in the exemptive rules.

These are a few of my concerns with abdication of our Congressional role to the SEC. There are more. I believe, however, the foregoing examples well illustrate the essential role of Congress in giving the mutual fund industry back to its owners—the 91 million American investors who will rely on mutual fund investment for their college and retirement security. They would be big winners under this legislation—and the big losers would be high-cost funds that cannot compete in a fair market.

Thank you again, Mr. Chairman, for the opportunity to testify today. I look forward to continuing to work with this Committee as it considers reporting the Mutual Fund Reform Act to the full Senate for consideration.

PREPARED STATEMENT OF SUSAN M. COLLINS

A U.S. SENATOR FROM THE STATE OF MAINE

MARCH 31, 2004

Chairman Shelby, Senator Sarbanes, and Members of the Committee, thank you for inviting me to testify on legislation that I have introduced with Senators Fitzgerald and Levin, who have spent an enormous amount of time examining the complex issues involving mutual funds. Our bill, The Mutual Fund Reform Act, is a comprehensive approach that contains many different proposals for strengthening our system of mutual fund regulation. I commend the Committee for your work on these issues that affect approximately 95 million investors who have invested more than $7 trillion into mutual funds.

As the Committee on Governmental Affairs pursued its investigation of mutual funds, I thought about a fundamental question. Why is it that in a society built on competition, market forces do not drive down mutual fund fees? Why is it that the legendary American consumer, who will search for the cheapest gas, clip newspaper coupons, and take advantage of early bird specials, is oblivious to fees that can, over time, affect his or her net worth by thousands of dollars? Why is it that mutual fund fees seem more impervious to competitive forces than almost any other cost in our society, surpassed, in this regard, perhaps only by college tuition?

I start with the basic notion that competition can only work when market participants have adequate information. If mutual fund investors do not fully understand either the level of their fees or their impact on fund performance, competition lacks one of its essential ingredients. Furthermore, if this is true of many mutual fund investors, then we cannot expect the informed decisions of the majority to protect the uninformed choices of the minority, as occurs in markets that are efficient. This theory would suggest that the Government should act to improve either the amount of fee information provided to investors or the clarity with which it is presented, or both.

The most important reform that can be made, in my view, is to focus investors' attention on the costs of owning mutual funds. For most investors, high mutual fund expenses will cost them more than such abusive practices as "market timing" or "late trading." For example, assume a worker chooses a mutual fund at the beginning of her career. Should she choose one with high returns in recent years and expenses of 1.5 percent? Or should she choose another with steadier, less spectacular recent returns with only a 0.5 percent expense ratio? Unfortunately, there is a very good chance that she will choose the former when choosing the latter would, by the end of her career, have returned 35 to 40 percent more money in this particular case.

We cannot enjoy the benefits of competition unless we have an efficient marketplace. And, an efficient marketplace requires that prices be both transparent and easily accessible to investors. Currently, however, mutual fund expenses and fees are often opaque and obscure. In contrast, historical performance is well known as successful funds tout the past performance data that puts them in the best light through large advertising campaigns.

The American Enterprise Institute's Shadow Financial Regulatory Committee, which is comprised of some of the top economists and financial experts in the country, recently stated:

> Mutual fund expenses are an important determinant of investors' actual returns. Though market fluctuations may swamp the impact of fund expenses on short-run returns, such expenses become much more significant in determining differential returns among funds over a number of years. Therefore, expense ratios are particularly important to long-term investors.

I recognize the impediments to calculating the true costs of mutual funds. Most important, mutual fund trading costs, which funds pay to brokers when the fund buys or sells securities for its portfolio, are not included in the expense ratio, which is the most commonly used mutual fund cost metric.

Compounding this problem, there are many expenses that are bundled in with these transactions, which means that even more mutual fund expenses never make it into the expense ratio. They include research and related costs, which are purchased with so-called "soft dollars." Another example is the practice of "directed brokerage," by which trades are executed with certain brokers that sell the fund's shares, and are understood by both parties to be a form of compensation for such sales. This practice, in essence, combines distribution costs with brokerage costs and becomes a hidden 12b–1 fee.

The SEC made a good start in improving cost disclosure with its recent proposal that mutual funds disclose their costs per thousand dollars invested in the funds' shareholder reports. I believe, however, that Congress should go further. S. 2059, for example, would require that personalized data be published on a shareholder's account statement at least annually.

It is not enough to tell an investor how much his costs would have been had he owned an amount of shares he does not actually own. Like a bank checking statement that tells a bank customer how much he or she was charged for individual banking services, a mutual fund statement should tell an investor how much his or her actual share of the fund's fees were.

I realize, Mr. Chairman, that there would be costs to generating and reporting personalized cost data to each mutual fund investor. Still, having reviewed work done by the General Accounting Office (GAO), I have concluded that this disclosure is warranted, just as it is in other types of financial records, such as checking account statements.

Specifically, using industry data, GAO calculated that, spread out over the vast number of accounts, such disclosure would cost each fund account holder about 65 cents every year after a one dollar initial cost.

Also, I would urge the Committee to report mutual fund reform legislation as soon as possible, so that it can be enacted prior to adjournment.

The Investment Company Act, which is the principal statute governing mutual funds, was originally passed in 1940. As originally enacted, the Investment Company Act of 1940 was considered to be a weak law. It has not been significantly amended since 1970. At 64 years of age, the law governing mutual funds is therefore approaching what we typically consider to be retirement age. Although I do not think we need to retire the 1940 Act, leaving matters to the SEC alone would be, in my view, an insufficient response to the recent revelations about wrongdoing in the mutual fund industry.

This is not to slight the SEC's recent activities. The SEC has taken many steps to improve the oversight and regulation of the mutual fund industry. They include new proposals regarding fund governance, broker compensation disclosure, and many other facets of mutual fund regulation. The end result of all of this activity will be a better-regulated and safer environment for Americans to invest in mutual funds. Still, I want to urge the Committee to report mutual fund reform legislation so that we can ensure that reforms endure regardless of who becomes future members of the SEC.

Since their earliest conception as 19th century English investment trusts, mutual funds have been touted as allowing small investors access to the same advantages enjoyed by larger and wealthier investors. What we have learned from practices such as "late trading" and "market timing," however, is that there has all too often been two sets of rules—one for favored investors, and another for everyone else. Although American families continue to invest in mutual funds, their continuing trust in them and our capital markets in general is not something that we can take for granted. We must not only address abusive practices but also, arguably even more important, excessive fees, and we must do so in a manner that maximizes investor faith in the mutual fund industry.

Striking the right balance, Mr. Chairman, is the job of you and your colleagues on this Committee. I wish you well in your efforts, as I believe that protecting our Nation's mutual fund investors is one of the most important tasks that your Committee could undertake this Congress.

PREPARED STATEMENT OF CARL LEVIN

A U.S. SENATOR FROM THE STATE OF MICHIGAN

MARCH 31, 2004

Chairman Shelby, Ranking Member Sarbanes, other Members of the Banking Committee, thank you for inviting us here today to testify about what needs to be done to tackle the abuses associated with the recent mutual fund scandals. Your series of hearings shows the same thoughtfulness and thoroughness that this Committee displayed in response to the corporate scandals of 2002, and, I hope, will also result in sensible and meaningful reforms this year.

When Enron, WorldCom, Global Crossing, and other scandals exploded onto the scene in late 2001 and early 2002, this Committee acted with deliberation, but it also did not let these scandals fester. Within a year, you produced a bipartisan bill, and moved it through the Senate. Enactment of the Sarbanes-Oxley Act of 2002 was a proud moment for this Committee, for the Senate, and for the country.

With respect to mutual funds, 7 months have now passed since abusive practices and allegations of wrongdoing came to light. Late trading, market timing, hedge fund favoritism, hidden fees, and other abuses have sullied an industry. These mutual fund abuses should not be allowed to infect investor confidence. With your leadership, Congress will again act decisively to restore investor confidence in what has been a powerful source of investment capital for the markets and a critical source of savings for millions of average American families.

I want to recognize and acknowledge the important enforcement and regulatory actions already taken by the SEC. These actions have sent a message to wrongdoers seeking to take advantage of mutual fund investors. But as much as the SEC has done, it doesn't have the authority to undertake certain key mutual fund reforms. Congress should strengthen the hand of the SEC by taking a stand on these issues and placing mutual fund reforms in statutory law.

Over 95 million Americans now invest more than $7 trillion in mutual funds. These investors deserve complete and accurate information about mutual fund costs so they can make informed decisions and comparison shop to find well-run, efficient mutual fund products. They need to have confidence that the fees they pay are legitimate. They also deserve to know that the persons advising them relative to their investments are exercising independent and objective judgments.

Unfortunately, significant conflicts of interests in the industry today have undermined confidence in some of the investment advice being offered on the market. It is essential that we act to eliminate these conflicts. The Mutual Fund Reform Act, which was introduced in February by Senators Fitzgerald, Collins and me, zeroes in on, among other things, the conflicts of interest problem. And it takes the approach of banning rather than simply disclosing unacceptable conflicts of interest that undermine public confidence in the mutual fund market.

Disclosure is not enough to address the conflicts problems in the mutual fund field. Complicated disclosures of such practices as revenue sharing and directed brokerage would, I am afraid, confuse and overwhelm average investors. Just look at what disclosure has done to our telephone bills — there are pages of information, but the sheer length and amount of unfamiliar data make it virtually impossible to decipher.

Mutual fund data is even more complex than long distance and local call data, and it unlikely that meaningful disclosures can be designed to educate investors and stamp out conflict of interest abuses.

The conclusion our bill reaches is that a disclosure-only regime is not enough. Mere disclosure also blurs a key point: The conflicts are not acceptable—period. Instead, we prohibit those practices that embody conflicts of interest and undermine confidence in the market. I would like to briefly touch on a few of the conflicts of interest that our bill has determined need to be ended, not continued under a cloak of disclosure, if we are to act forcefully to restore confidence in the mutual fund industry.

Revenue Sharing

A key conflict of interest targeted by our bill is a practice known as revenue sharing. Revenue sharing occurs when a mutual fund manager pays a broker to promote the mutual fund to the broker's clients. This payment creates a clear conflict of interest by throwing in a new factor for an investment advisor to consider—his or her company's own financial profit—when deciding which mutual funds to recommend to an investor. The SEC recently conducted a review of the 15 largest Wall Street brokerage firms to determine the extent of revenue sharing between those firms and various mutual funds. It found that 14 of the 15 brokerage firms received payments from mutual funds in exchange for steering their clients toward those funds.

The SEC and the National Association of Securities Dealers (NASD) have proposed addressing this issue by requiring brokers to disclose revenue sharing payments to their clients at the time of purchase. But disclosure is not enough. Even if an investor is clearly told that his or her broker is getting paid to promote a mutual fund, the investor is left wondering whether the broker's recommendation is based on the mutual fund's merits or the broker's financial benefit. Disclosure does not resolve the conflict; it allows revenue sharing payments to continue to undermine objective investment advice. The better course of action is to ban revenue sharing from the mutual fund marketplace.

Directed Brokerage

A second conflict of interest targeted by our bill is directed brokerage. In directed brokerage, a mutual fund typically promises to buy a certain amount of brokerage services from a broker-dealer who agrees to promote that mutual fund to investors. Like revenue sharing, this practice undermines objective investment advice, to the detriment of average investors. To its credit, the SEC has already proposed prohibiting, rather than just disclosing, directed brokerage. Our bill would provide the SEC's proposed ban with a statutory basis, helping the SEC to remove another cloud over the objectivity of investment advice.

Independent Directors

A third conflict of interest I want to mention today involves mutual fund directors. Recent scandals have disclosed a number of problems with mutual fund boards of directors. In some cases, the same person is the chairman of the board of both the mutual fund and the fund manager, meaning that when fees are negotiated, the same person is on both sides of the table. In other cases, close relations between a mutual fund's board members and its management company leads to lax oversight and a misplaced reliance on the managers to protect shareholder interests. Shareholders are best represented when board members engage in active oversight and arms-length negotiations with management over expenses and investment decisions. The SEC has already proposed requiring that 75 percent of each mutual fund board members be independent from the fund's management, for example the people who set up the fund, and that an independent chairman sit at the helm. Our bill would, again, strengthen the SEC's position.

Mutual Fund Expense Disclosures

I want to mention one other topic, the importance of enacting legislation establishing a standard for calculating and disclosing mutual fund expenses that includes all material costs. The current "expense ratio" calculation allows funds to leave out key transactional expenses like brokerage commissions, which means that investors cannot accurately comparison shop to find well-run, low-cost mutual fund products. Just like grocery shelf price tags give a "price per ounce" so shoppers can assess the price savings between different brands and sizes, investors should have access to a cost ratio that includes all expenses and allows easy and accurate comparisons between mutual funds. Expense disclosures that are comprehensive, easy to understand, and easy to compare are critical to creating a vibrant and fair mutual fund market and guaranteeing investors access to the information they need to make informed choices.

Mutual funds are a $7 trillion engine of growth for our economy and investment of choice for many average Americans. I urge this Committee to act decisively and to act this year so the Senate can consider meaningful investor protections and help restore the confidence needed to keep this mutual fund engine humming.

PREPARED STATEMENT OF DANIEL K. AKAKA

A U.S. SENATOR FROM THE STATE OF HAWAII

MARCH 31, 2004

Thank you, Chairman Shelby and Ranking Member Sarbanes, for the opportunity to participate in today's hearing.

Mutual fund reform is important because 95 million people have placed a significant portion of their future financial security into mutual funds. Mutual funds provide middle-income Americans with an investment vehicle that offers diversification and professional money management. Mutual funds are what average investors rely on for retirement, savings for children's college education, or other financial goals and dreams.

On November 5, I introduced S. 1822, the Mutual Fund Transparency Act of 2003. I believed that legislation was necessary to bring about structural reform in the mutual fund industry, increase disclosures in order to provide useful and relevant information to mutual fund investors, and restore trust among investors. I was appalled by the flagrant abuses of trust among mutual fund companies.

I commend the SEC for its proposals to improve the corporate governance of mutual funds and to increase the transparency of mutual fund fees that investors pay. The proposed requirements for an independent chairman for mutual fund boards, increased percentage of independent directors to 75 percent, and development of a confirmation notice so that investors will be able to know how their broker gets paid in mutual fund transactions are a solid and measured response to the litany of transgressions which have undermined public confidence in the mutual fund industry. These provisions mirror those in my legislation. In addition, I have been impressed with the SEC's attempts to address point-of-sale disclosure.

However, I continue to believe that legislation is necessary to codify some of the proposed regulations so that the reforms will not be rolled back in the future. It is also important to legislatively address areas where the SEC needs additional statutory authority to address problems and abuse in the mutual fund industry. Mr. Mercer Bullard, in his testimony before this Committee, indicated that the "Commission's proposal does not effectively require fund boards to be 75 percent and have an independent chairman" because the rules would only apply to funds that rely on one or more of the exemptive rules. This means that these rules would not apply to all funds. Legislation is necessary to ensure corporate governance improvements apply these rules universally among mutual funds. Finally, additional legislation may be necessary if disclosures of revenue sharing agreements and portfolio transaction costs are not adequately addressed by the Commission.

S. 1822 includes a number of provisions that are important for Congress to enact. Boards must be strengthened and more independent to be more effective. Investment company boards should be required to have an independent chairman, and independent directors must have a dominant presence on the board. My bill strengthens the definition of who is considered to be an independent director. It also requires that mutual fund company boards have 75 percent of their members considered to be independent. To be considered independent, shareholders would have to approve them. In addition, a committee of independent members would be responsible for nominating members and adopting qualification standards for board membership. These steps are necessary to add much needed protections to strengthen the ability of mutual fund boards to detect and prevent abuses of the trust of shareholders.

My bill will also increase the transparency of often complex financial relationships between brokers and mutual funds in ways that are meaningful and easy to understand for investors. Shelf-space payments and revenue-sharing agreements between mutual fund companies and brokers present conflicts of interest that must be addressed. Shelf-space and revenue sharing agreements present risks to investors. Brokers have conflicts of interest, some of which are unavoidable, but these need to be disclosed to investors. Without such disclosure, investors cannot make informed financial decisions. Investors may believe that brokers are recommending funds based on the expectation for solid returns or low volatility, when the broker's recommendation may be influenced by hidden payments. S. 1822 will require brokers to disclose in writing, to those who purchase mutual fund company shares, the amount of compensation the broker will receive due to the transaction, instead of simply providing a prospectus. The prospectus fails to include the detailed relevant information that investors need to make informed decisions. Prior to their recent rulemaking, the SEC exempted mutual funds from Rule 10b–10, which requires that confirmation notices of securities transactions be sent to customers to indicate how the broker was compensated in the trade. My legislation would prevent the exemption of mutual funds from confirmation notice requirements.

To increase the transparency of the actual costs of the fund, brokerage commissions must be counted as an expense in filings with the SEC and included in the calculation of the expense ratio, so that investors will have a more realistic view of the expenses of their fund. Consumers often compare the expense ratios of funds when making investment decisions. However, the expense ratios fail to take into account the costs of commissions in the purchase and sale of securities. Therefore, investors are not provided with an accurate idea of the expenses involved. Currently, brokerage commissions have to be disclosed to the SEC, but not to individual investors. Brokerage commissions are only disclosed to the investor upon request. My bill puts teeth into brokerage commission disclosure provisions and ensures commissions will be included in a document investors actually have access to and utilize.

The inclusion of brokerage commissions in the expense ratio creates a powerful incentive to reduce the use of soft dollars. Soft dollars can be used to lower expenses since most purchases using soft dollars do not count as expenses and are not calculated into the expense ratio.

There have been calls for the prohibition of soft dollars. This is a recommendation that needs to be examined. However, my bill provides an immediate alternative, which is an incentive for funds to limit their use of soft dollars by calculating them as expenses. If commissions are disclosed in this manner, the use of soft dollars will be reflected in the higher commission fees and overall expenses. This makes it easier for investors to see the true cost of the fund and compare the expense ratios of funds.

Some may argue that this gives an incomplete picture and fails to account for spreads, market impact, and opportunity costs. However, the SEC has the authority to address the issue further if it can determine an effective way to quantify these additional factors. My bill does not impose an additional reporting requirement that would be burdensome to brokers. It merely uses what is already reported and presents this information in a manner meaningful to investors.

One of the provisions in my bill requires the SEC to conduct a study to assess financial literacy among mutual fund investors. This study would identify the most useful and relevant information that investors need prior to purchasing shares, methods to increase transparency of expenses and potential conflicts of interest in mutual fund transactions, existing efforts to educate investors, and a strategy to increase the financial literacy of investors that results in positive change in investor behavior. This study is necessary because any additional disclosure requirements for mutual funds will not truly work unless investors are given the tools they need to make smart investment decisions, and we must first know what education exists.

I look forward to working with my colleagues and the SEC to address problems identified in the mutual fund industry.

STATEMENT OF PAUL G. HAAGA, JR.

EXECUTIVE VICE PRESIDENT

CAPITAL RESEARCH AND MANAGEMENT COMPANY

AND

CHAIRMAN

INVESTMENT COMPANY INSTITUTE

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

UNITED STATES SENATE

ON

REVIEW OF CURRENT INVESTIGATIONS AND REGULATORY ACTIONS REGARDING THE MUTUAL FUND INDUSTRY:

FUND COSTS AND DISTRIBUTION PRACTICES

MARCH 31, 2004

I. INTRODUCTION

My name is Paul G. Haaga, Jr. I am Executive Vice President and Chairman of the Executive Committee of Capital Research and Management Company, the investment adviser to the 29 funds in The American Funds Group, with more than $500 billion in assets under management. The American Funds Group is the third largest mutual fund group in the United States and the largest group distributed exclusively through unaffiliated financial advisors. Before I joined the American Funds in 1985, I was a securities attorney in private practice in Washington, D.C. and, prior to that, was on the staff of the Securities and Exchange Commission. I also serve as the Chairman of the Board of Governors of the Investment Company Institute, the national association of the American investment company industry. My testimony today is offered on behalf of the Institute and its members.[1]

I appreciate the opportunity to appear before the Committee today to discuss ongoing efforts to respond to revelations of abusive mutual fund trading practices and to proffer the industry's continued commitment to take whatever steps are necessary to make sure that the interests of fund shareholders are fully protected.

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[1] The Investment Company Institute is the national association of the American investment company industry. Its membership includes 8,625 open-end investment companies ("mutual funds"), 611 closed-end investment companies, 124 exchange-traded funds and 6 sponsors of unit investment trusts. Its mutual fund members have assets of about $7.457 trillion. These assets account for more than 95% of assets of all U.S. mutual funds. Individual owners represented by ICI member firms number 86.6 million as of mid 2003, representing 50.6 million households.

Since the allegations of late trading, abusive short-term trading and selective disclosure of portfolio holdings were first revealed in early September of last year,[2] the industry has been under intense scrutiny from many directions. All share with us the common goal of protecting the interests of fund shareholders.

The Securities and Exchange Commission and the New York Attorney General's office have been conducting widespread investigations into these alleged abusive practices and have taken forceful action where wrongdoing is found. It is imperative that the ongoing investigations by the SEC and others are thorough and successful in rooting out trading activities that may have compromised the interests of individual mutual fund shareholders.

Notably, the marketplace has already meted out harsh punishment to firms charged with harming their fund shareholders' interests. There is no more powerful way to communicate the message that the trust and confidence of investors can never be taken for granted.

The Congress, including this Committee, has a keen interest in assuring that mutual funds are operated in the interests of investors and has acted quickly and responsibly by holding hearings to elicit the views of experts and interested parties on a range of important issues. The Institute agrees that it is necessary and entirely appropriate for the Committee to engage in a thorough, deliberative process in order to have a well-informed basis for determining what remedial actions may be needed.

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[2] *See State of New York v. Canary Capital Partners, LLC, Canary Investment Management, LLC, Canary Capital Partners, Ltd. and Edward J. Stern* (NY S. Ct. filed Sept. 3, 2003) (undocketed complaint) ("Canary Complaint").

Mutual fund sponsors themselves also have acted swiftly to determine whether wrongdoing occurred in their firms. They have conducted internal investigations, in some cases aided by independent outside experts to investigate and judge the findings, and communicated their findings and responses to their boards and shareholders. In addition, some fund boards have retained independent third parties to conduct investigations. As a result of these investigations, several funds have terminated senior executives. Many funds have committed to taking remedial actions, including compensating fund shareholders for any detrimental impact that improper or illegal transactions may have had on their investments. Our responses to shareholders and regulators reinforce that funds take very seriously their obligations under the federal securities laws and the fulfillment of their responsibility to make sure that investors' interests always come first.

In addition to seeking to determine whether any wrongdoing occurred, fund firms have conducted thorough reviews of their policies and procedures in the principal areas that have been the subject of recent enforcement proceedings. These reviews have provided an opportunity to assess whether existing policies and procedures continue to operate effectively or whether enhancements may be needed. Fund boards have been actively involved in overseeing these reviews.

The Institute also has made several recommendations for significant regulatory enhancements to address the specific issues raised by the abuses that have been uncovered, as well as other important issues. Finally, the SEC has pursued, at a record pace, the most aggressive and wide-ranging mutual fund regulatory reform agenda in recent history. These

recommendations and regulatory initiatives are discussed below.[3] My testimony will first describe initiatives to address the mutual fund trading abuses referred to above. It will then discuss other initiatives to reinforce the protection and enhance the confidence of mutual fund investors.

II. INITIATIVES TO ADDRESS MUTUAL FUND TRADING ABUSES

A. Late Trading

To address the problem of late trading, the Institute last October called for a tightening of existing regulations to require that all purchase and redemption orders be received by a fund (or its transfer agent) before the time of pricing (generally 4:00 p.m. Eastern time).[4] The Institute recognized that this approach could have a significant impact on many investors who own fund shares through financial intermediaries, but concluded that the recent abuses indicated that the strongest possible measures are necessary to ensure investor protection. In December, the SEC proposed rule amendments that would take an approach consistent with the Institute's recommendation.[5] As noted in the Institute's comment letter on the SEC's proposal, the

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[3] In order for the SEC to develop appropriate regulatory initiatives to respond to the trading abuses that have occurred, and to successfully carry out its oversight and inspection duties with respect to mutual funds, it is critically important that the SEC have sufficient resources. The industry has consistently supported adequate funding for the SEC, and recently expressed strong support for the Bush Administration's proposed FY 2005 budget for the SEC, which would provide a significant and necessary increase over the record amount appropriated for the current fiscal year. *See* Letter from Matthew P. Fink, President, Investment Company Institute, to The Honorable Ted Stevens, Chairman, Committee on Appropriations, United States Senate, dated February 11, 2004.

[4] Most funds price their shares as of 4:00 p.m. Eastern time, the normal close of regular trading on the New York Stock Exchange. Thus, for simplicity, the discussion below assumes that this is the case. A fund that prices its shares as of a different time should be required to cut off orders by that time.

[5] In addition to the fund and its designated transfer agent, the SEC's proposal would allow orders to be received by a registered clearing agency. *See* SEC Release No. IC-26288 (December 11, 2003).

Institute's support for a "hard 4:00 p.m. cut-off" requirement is based, in large part, on the concern that existing technology may not be sufficient both to provide an unalterable date and time stamp for a trade at the time it is actually received by a fund intermediary and to prevent investors from placing trades prior to the time a fund prices it shares, only to cancel such trades once the price is determined by the fund.[6] The Institute's letter encouraged the SEC to consider expanding the list of entities that may receive orders on behalf of a fund for pricing purposes to the extent that the SEC is able to assure itself that technology exists that would enable intermediaries to document, through unalterable means, the precise date and time when they received an order and ensure that orders received prior to the time the fund prices its shares are processed and not cancelled once the fund's share price is determined. We understand that the SEC is now analyzing the hundreds of comment letters submitted in response to the proposal, and are confident that an appropriate solution will be reached.

B. Market Timing

As noted above, the ongoing investigations by the SEC and other governmental officials also involve issues relating to market timing of mutual funds. The specific concerns that have been raised about market timing are not that funds did, or did not, have certain policies in place. Rather, it has been discovered that certain fund management officials at some funds may have authorized activities that called into question whether the funds were applying their market timing policies fairly and consistently. The Institute has called for and/or endorsed a number of different steps to address these concerns.

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[6] *See* Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Mr. Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission, dated February 5, 2004.

1. Written Policies and Procedures; Disclosure

Last fall, SEC Chairman Donaldson outlined various regulatory measures that the SEC staff was considering to address the practice of various individuals at certain funds allowing a few investors to engage in market timing activities in a manner inconsistent with the funds' policies.[7] These measures included new rules and form amendments to (1) require explicit disclosure in fund offering documents of market timing policies and procedures and (2) require funds to have procedures to comply with representations regarding market timing policies and procedures. Chairman Donaldson also indicated that the SEC would consider measures to reinforce board oversight of market timing policies and procedures. The SEC has recently taken formal action in these areas.[8]

The Institute and its members fully support these measures.[9] While many funds already have market timing policies and procedures, requiring funds to adopt formal and detailed policies and procedures in this area and specifically providing for board oversight will ensure that all funds have tools in place to identify and swiftly respond to potentially abusive activity.

[7] SEC Chairman Donaldson Releases Statement Regarding Initiatives to Combat Late Trading and Market Timing of Mutual Funds, SEC Press Release No. 2003-136 (October 9, 2003).

[8] *See* SEC Release No. IC-26287 (December 11, 2003) (proposing amendments to require mutual funds to disclose in their prospectuses both the risks to shareholders of the frequent purchase and redemption of fund shares, and fund policies and procedures with respect to such frequent purchases and redemptions) ("SEC Disclosure Proposals") and SEC Release No. IC-26299 (December 17, 2003) (adopting Rule 38a-1 under the Investment Company Act of 1940 concerning mutual fund compliance programs) ("SEC Compliance Rule Release"). New Rule 38a-1 requires mutual funds to adopt and implement written policies and procedures reasonably designed to prevent violation of the federal securities laws, including procedures reasonably designed to ensure compliance with disclosed policies regarding market timing. In addition, it requires a fund's chief compliance officer to provide a written report to the fund's board, no less frequently than annually, that addresses, among other things, the operation of the fund's compliance policies and procedures and material compliance matters that occurred since the date of the last report.

[9] *See, e.g.,* Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Mr. Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission, dated February 5, 2004 (commenting on SEC Disclosure Proposals) ("ICI Comments on SEC Disclosure Proposals").

Such a requirement should also provide a more effective mechanism for boards and regulators to police compliance, because more formal policies likely will limit discretion in dealing with short-term traders. Fund shareholders also will benefit from additional prospectus disclosure about a fund's policies on short-term trading by gaining an understanding of how the fund will protect their interests from abusive activity. Requiring that such disclosure be in a fund's prospectus could serve to enhance compliance with the policies. The disclosure also could have a deterrent effect by alerting potential abusers to the fund's policies.[10]

The Institute has called for additional steps to address alleged abusive market timing activity by fund insiders, noting that this conduct, if true, is especially reprehensible. Thus, the Institute has urged all mutual funds and their advisers to clarify or amend their codes of ethics to require oversight of personal trading activity of the funds' portfolio managers and senior executives in shares of the funds. Consistent with the Institute's recommendation, the SEC recently proposed to require registered investment advisers to adopt codes of ethics that, among other things, set forth conduct expected of advisory personnel and require advisory personnel to report their personal securities transactions, including transactions in any mutual funds managed by the adviser.[11] The Institute supports the SEC's proposal.[12]

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[10] Of course, it will be important for any new disclosure requirements to allow funds to achieve an appropriate balance between providing disclosure that would have these beneficial effects and providing overly specific disclosure that inadvertently could serve as a roadmap for potential abusers to circumvent fund policies.

[11] *See* SEC Release Nos. IA-2209; IC-26337 (January 20, 2004) ("SEC Code of Ethics Proposal").

[12] *See* Letter from Amy B.R. Lancellotta, Acting General Counsel, Investment Company Institute, to Mr. Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated March 15, 2004. The Institute recommended certain technical changes to facilitate compliance with the proposed requirements.

2. Fair Valuation

As discussed above, an issue related to market timing is the obligation of funds to determine the fair value of their portfolio securities under certain circumstances. This is because, when fund share prices are based on closing market prices established some time before a fund's net asset value is set, short-term traders may seek to take advantage of this situation.

The SEC has recently taken steps to minimize the possibility that long-term fund shareholders' interests will be harmed by the activities of arbitrageurs seeking to take advantage of stale prices. The SEC issued a statement regarding fair value pricing requirements in its release adopting the mutual fund compliance program rule.[13] In addition to describing the SEC's position on when funds must use fair value pricing, the release states that the compliance program rule requires funds to adopt policies and procedures that require the fund to monitor for circumstances that may necessitate the use of fair value prices; establish criteria for determining when market quotations are no longer reliable for a particular portfolio security; provide a methodology or methodologies by which the fund determines the current fair value of the portfolio security; and regularly review the appropriateness and accuracy of the method used in valuing securities, and make any necessary adjustments. [14] SEC examinations

[13] *See* SEC Compliance Rule Release, *supra* note 8.

[14] *Id.* at 16-17. The ICI has published two compliance papers for its members on valuation issues, which are intended to assist them in meeting their regulatory responsibilities and in ensuring that fund share prices are fair to purchasing, redeeming and existing shareholders. *See* Investment Company Institute, *Valuation and Liquidity Issues for Mutual Funds* (February 1997) and Investment Company Institute, *Valuation and Liquidity Issues for Mutual Funds, 2002 Supplement* (March 2002).

of funds will provide the opportunity further to reinforce and monitor the implementation of applicable requirements in this area.[15]

Fair valuation can reduce the impact of harmful market timing activity, but it is important to recognize that it cannot by itself completely eliminate such trading. Accordingly, funds often employ additional methods to deter market timing activity.

3. Tools to Deter Market Timing

Funds devote significant resources to combating market timing activity. The investigations referred to above all involved situations where fund employees allegedly granted exceptions from stated policies against market timing. However, the various means that funds have employed to deter market timing may not have been fully effective even where enforcement was diligent and no exceptions were made for favored clients. For this reason, the Institute has advocated giving funds additional "tools" to restrict trading activity that they determine to be harmful to their shareholders, such as allowing funds to impose a redemption fee (which is a fee paid directly to the fund to offset the costs resulting from short-term trading) greater than the 2% maximum level currently permitted by the SEC staff. The Institute has met with the SEC staff several times to discuss these issues. In 2002, in response to an Institute

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[15] The SEC also has proposed revisions to clarify prospectus disclosure requirements concerning fair value pricing. The proposal is intended to make clear that all funds (other than money market funds) are required to explain briefly in their prospectuses both the circumstances under which they will use fair value pricing and the effects of using fair value pricing. In addition, the proposed revisions are intended to clearly reflect that funds are required to use fair value prices any time that market quotations for their portfolio securities are not readily available (including when they are not reliable). *See* SEC Disclosure Proposals, *supra* note 8. The proposed revisions should serve as a useful complement to the requirements articulated in the SEC Compliance Rule Release and the proposed disclosure of market timing policies and procedures discussed above.

request, the SEC staff issued a letter clarifying that funds may delay exchange transactions (*e.g.*, until the next business day) in order to deter abusive short-term trading.[16]

A particular challenge that funds face in effectively implementing restrictions on short-term trading is that many fund investments are held in omnibus accounts maintained by an intermediary (*e.g.*, a broker-dealer or a retirement plan record keeper). Often in those cases, the fund cannot monitor trading activity by individual investors in these accounts.[17]

Steps clearly need to be taken to enable mutual funds to enforce more effectively restrictions they establish on short-term trading when such trading takes place through omnibus accounts. The Institute has recommended, and the SEC recently proposed, an approach under which most types of funds would be required, at a minimum, to impose a 2% redemption fee on any redemption of fund shares within 5 days of purchasing them. If funds had a standardized minimum redemption fee along these lines, it would make implementation more cost-effective and thus should encourage intermediaries to establish and maintain the requisite systems to enforce payment of those fees.

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[16] *See* Investment Company Institute (pub. avail. Nov. 13, 2002) (expressing the SEC staff's agreement that a fund may, consistent with Section 11(a) of the Investment Company Act, make an exchange offer on a specified delayed basis, so long as the offer is fully and clearly disclosed in the fund's prospectus).

[17] The Canary Complaint describes this practice as follows: "Timers . . . trade through brokers or other intermediaries . . . who process large numbers of mutual fund trades every day through omnibus accounts where trades are submitted to mutual fund companies en masse. The timer hopes that his activity will not be noticed among the 'noise' of the omnibus account." Canary Complaint, *supra* note 2, at par. 46.

C. Selective Disclosure of Portfolio Holdings

The SEC and other regulators are investigating allegations that certain officials at some funds may have provided information about fund portfolio holdings to a few, select shareholders in order to enable them to trade ahead of the fund or to facilitate their abusive trading activities, to the potential detriment of the other shareholders. As the Institute has previously stated, funds and their shareholders would benefit from additional, more specific regulatory requirements in this area.[18]

The SEC has taken several actions toward this end. First, the SEC Compliance Rule Release states that a fund's compliance policies and procedures under the rule should address potential misuses of nonpublic information, including the disclosure to third parties of material information about the fund's portfolio.[19] Second, the SEC has proposed to require funds to disclose their policies and procedures with respect to the disclosure of portfolio securities, and any ongoing arrangements to make available information about their portfolio securities.[20] Third, as indicated above, the SEC has proposed to require investment advisers to adopt codes of ethics that, among other things, set forth standards of conduct expected of advisory personnel and safeguard material nonpublic information about client transactions.[21]

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[18] *See* Statement of Matthew P. Fink, President, Investment Company Institute, on "Review of Current Investigations and Regulatory Actions Regarding the Mutual Fund Industry," Before the Committee on Banking, Housing, and Urban Affairs, United States Senate (Nov. 18, 2003) ("Fink Statement"), at 14.

[19] *See* SEC Compliance Rule Release, *supra* note 8, at 19. The rule requires that the fund's board approve the policies and procedures. In addition, it provides for regular reporting to the board on the effectiveness of the policies and procedures, any changes thereto, and material compliance matters.

[20] *See* SEC Disclosure Proposals, *supra* note 8.

[21] *See* SEC Code of Ethics Proposal, *supra* note 11.

Similar to market timing, requiring funds to adopt formal policies should ensure that they have a system to prevent disclosure that is not in the best interests of shareholders (*e.g.*, because it would facilitate front-running or other abusive trading practices) and to police compliance. Board oversight and public disclosure will further enhance compliance with the policies. At the same time, the approach proposed by the SEC would preserve an appropriate degree of flexibility in how funds release information. The Institute supports the SEC's initiatives.[22]

D. Hedge Funds

1. Registration of Hedge Fund Advisers

The action brought by the New York Attorney General against Canary Capital also underscores the need for SEC oversight of hedge fund advisers. Currently, the SEC generally has access to records of trading on behalf of hedge funds through the records maintained by the brokers that the hedge fund advisers use and the markets on which they trade. The records, however, are dispersed and it is difficult to detect improper trading activities conducted by a particular hedge fund if such activities were effected through orders placed with multiple brokers and traded on multiple markets.

[22] *See* ICI Comments on SEC Disclosure Proposals, *supra* note 9.

Last fall, the SEC issued a staff report on hedge funds[23] that included a recommendation to require hedge fund advisers to register under the Investment Advisers Act of 1940. As the Staff Report indicates, by requiring hedge fund advisers to register, the SEC would be able to observe more comprehensively and effectively the trading activities of the funds managed by such advisers. As a result, the SEC would be in a better position to detect improper or illegal trading practices.[24] The Institute noted its support for the staff's recommendation in previous testimony before this Committee.[25]

2. Side-by Side Management of Hedge Funds and Mutual Funds

Some have expressed concerns about potential conflicts of interest faced by portfolio managers who manage both mutual funds and hedge funds. Advisers who manage both mutual funds and hedge funds *already* are fully subject to the SEC's jurisdiction, because all advisers to mutual funds must register with the SEC. Consequently, the SEC has the ability to take, and indeed recently has taken, actions that should help address these conflict of interest concerns. In particular, the SEC's new compliance program rule for investment advisers requires advisers to implement policies and procedures that address conflicts arising from management of multiple funds and accounts, such as the allocation of investment opportunities

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[23] Staff Report to the United States Securities and Exchange Commission, *Implications of the Growth of Hedge Funds* (Sept. 2003) ("Staff Report").

[24] *Id.* at 92-95.

[25] *See* Fink Statement, *supra* note 18, at 15.

and the allocation of aggregated trades.[26] In addition, the SEC recently proposed new disclosure requirements concerning conflicts of interest to which a portfolio manager may be subject as a result of managing a mutual fund and other portfolios, such as hedge funds.[27] The Institute believes that the SEC's approach of requiring advisers to adopt specific policies and procedures to deal with conflicts, coupled with disclosure, is an effective way to handle this issue. Importantly, it avoids the many negative consequences that would result if, as some have suggested, a portfolio manager were prohibited from simultaneously managing a mutual fund and a hedge fund. For example, mutual fund investors would have reduced access to the expertise of skilled investment professionals who, if forced to choose, likely would elect to manage other types of investment accounts that do not involve such restrictions. Also, such a prohibition would eliminate important operating efficiencies for investment management firms. It could have harsh, disruptive and anti-competitive effects, especially for smaller investment management firms that have fewer employees and may not have the resources to maintain separate staff for different types of accounts.

E. Fund Governance

The recent disturbing revelations about mutual fund abuses have caused some to question the effectiveness of the fund governance system. What we have learned about the problems that have occurred suggests management deficiencies at several fund groups rather

[26] The Institute recently published a paper to inform and assist its members generally with respect to issues relating to the side-by-side management of mutual funds and investment accounts. *See* Investment Company Institute, *Side-by-Side Management of Registered Investment Companies and Investment Accounts* (March 2004).

[27] SEC Release No. IC-26383 (March 11, 2004). The proposal also would require disclosure of the structure of portfolio manager compensation and ownership of shares of the funds that a manager advises, among other things.

than systemic corporate governance problems or serious flaws with the director oversight system. The Institute strongly believes that the fund governance system itself remains fundamentally sound. Nevertheless, the Institute supports reforms that will improve the system and promote investor confidence.[28]

One such reform is the SEC's mutual fund compliance program rule, discussed above. The Institute believes that this rule will greatly assist fund directors in serving effectively in their oversight role by requiring funds to have comprehensive compliance policies and procedures in place and by improving the flow of information about significant compliance issues to the directors. In addition, the SEC has proposed certain new fund governance requirements that should help enhance the independence and effectiveness of fund boards and promote investor confidence.[29] Certain other proposals to "improve" fund governance in the wake of the recent scandals are, however, unwarranted and counterproductive.

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[28] Consistent with this, in October 2003, the Institute's Board of Governors unanimously adopted a resolution recommending that mutual funds adopt additional governance best practices that would (1) prohibit close family members of persons associated with a fund or certain affiliates from serving as independent directors and (2) apply to mutual fund audit committees standards that are similar to those applicable to the audit committees of operating companies under the Sarbanes-Oxley Act.

[29] The SEC has proposed to require, among other things: that the independent directors meet in separate sessions at least once each quarter; that funds authorize the independent directors to hire their own staff; and that the board perform an annual self-assessment that would include consideration of the board's committee structure and the number of boards on which the directors sit. *See* SEC Release No. IC-26323 (January 15, 2004) ("SEC Fund Governance Proposals"). The Institute supports these measures. *See* Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated March 10, 2004. In addition, the SEC has proposed to require that independent directors constitute at least 75% of each fund board. As indicated in the Institute's comment letter to the SEC, while the Institute supports requiring a supermajority of independent directors, it seems highly unlikely that the marginal benefits, if any, of a 75% requirement would outweigh the disruption involved in imposing that standard rather than codifying the two-thirds supermajority that most fund boards have. The SEC also has proposed to require fund boards to appoint an independent chair which, as discussed in more detail below, the Institute believes should not be mandated for all fund boards.

One such proposal would require mutual fund boards to have an independent chair. While some fund boards may choose to have an independent chair, not all fund boards may find that this structure works best for them.[30] Independent directors constitute at least a majority (and in most cases a supermajority) of a mutual fund's board, meaning that they already have full power to appoint an independent chair if they wish to do so. Existing regulatory requirements and industry practices, as well as the other new fund governance requirements recently proposed by the SEC, also make a requirement to have an independent chair unnecessary. For example, the Investment Company Act requires a separate vote of the independent directors on most important decisions, such as approval of the fund's investment advisory and underwriting agreements, and the use of fund assets to support the distribution of fund shares under a Rule 12b-1 plan. Existing practices in the fund industry – such as a supermajority of independent directors, the appointment of lead independent directors and regular meetings of independent directors in executive session – further reinforce the independence and authority of the independent directors.[31]

More philosophically, it seems counterintuitive to *mandate* such a requirement, instead of allowing the directors to determine in their best judgment who is the most appropriate person to serve as the board's chair. This reasoning is reinforced by the fact that the SEC (and applicable law) already relies heavily on the independent directors' judgment with respect to protecting the interests of shareholders. Also, it is far from clear why mutual fund boards,

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[30] For example, some funds have found that having an interested director serve as board chair is beneficial in that it promotes administrative efficiencies.

[31] In addition, as noted above, the SEC's pending fund governance proposals would require that fund boards consist of a supermajority of independent directors and that the independent directors meet in separate sessions at least once each quarter. *See* SEC Fund Governance Proposals, *supra* note 29.

alone among all corporate boards, should be deprived of the discretion to choose their chairperson. Finally, it bears noting that some of the funds involved in the recent scandals have independent board chairmen. Thus, there is little empirical or practical evidence that requiring all fund boards to have independent chairs is the answer to the current problems.

There are better ways to assure that independent directors have sufficient avenues for addressing matters of concern to them, including the ability to place items on the board's agenda. For example, as indicated in the Institute's recent comment letter to the SEC, the SEC could require that both a majority of the board and a majority of the independent directors elect the chairman of the board annually. Alternatively, or in addition, the SEC could require funds that do not have an independent chair to appoint a "lead independent director" and/or to submit the agenda to the independent directors for review to ensure that all matters of concern to them are scheduled to be discussed.[32]

Another proposed response to the abusive trading practices would require independent directors, or an independent chair, to make a series of certifications, many of which relate to matters that are outside the scope of what an independent director could reasonably be expected to know (*e.g.*, that the fund is in compliance with certain policies and procedures

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[32] The appointment of one or more lead independent directors was one of several best practices that an advisory group convened by the Institute in 1999 recommended for adoption by fund boards. *See Enhancing a Culture of Independence and Effectiveness,* Report of the Advisory Group on Best Practices for Fund Directors (June 24, 1999). The House Financial Services Committee recently passed legislation that would amend Section 10(a) of the Investment Company Act to require funds that do not have an independent chairman of the board to select a lead independent director having certain minimum powers (including the authority to place items on the agenda for consideration). *See* Section 9 of H.R. 2179, the "Securities Fraud Deterrence and Investor Restitution Act," as passed by the House Financial Services Committee on February 25, 2004.

adopted by the board, such as fair value pricing policies and procedures).[33] Not only would this potentially expose certifying directors to increased liability, but it would not serve the best interests of fund shareholders. Independent directors (or the independent chair) would be faced with the Hobson's choice of either (1) seeking to secure and being forced to rely on a series of sub-certifications from those directly involved in the various matters to be certified (because the directors themselves would not be in a position to have personal knowledge of what they are certifying), or (2) immersing themselves in the day-to-day intricacies of fund operations, thereby inappropriately transforming their role from oversight to management and operational tasks. Both of these results would place the independent directors in an awkward and/or inappropriate position and neither would meaningfully improve investor protection. Finally, imposing a certification requirement on independent directors would create a strong disincentive against serving on fund boards without providing any compensating benefit. In fact, I have heard several directors from various fund groups indicate that they would simply resign from the board if such a requirement were put in place.

III. OTHER INITIATIVES TO PROMOTE INVESTOR CONFIDENCE

A. Brokerage Allocation Practices

In addition to calling for and supporting regulatory changes to protect investors against abusive mutual fund trading practices, the industry has been actively considering other ways to reinforce the protection and confidence of mutual fund investors. The Institute believes that the

[33] *See, e.g.*, Section 201 of H.R. 2420, the "Mutual Funds Integrity and Fee Transparency Act of 2003," as passed by the U.S. House of Representatives on November 19, 2003; Section 301 of S. 1971, the "Mutual Fund Investor Confidence Restoration Act of 2003," as introduced by Senators Corzine and Dodd on November 25, 2003.

time has come for a top to bottom reexamination of mutual fund brokerage allocation practices and the applicable regulatory requirements. Investment advisers, including advisers to mutual funds, may use the brokerage commissions from transactions for client accounts to obtain research products and services from broker-dealers and third parties ("soft dollar arrangements"). Advisers to funds also may take into account a broker-dealer's sales of fund shares in allocating brokerage ("directed brokerage"). While both of these practices are clearly permissible under existing applicable regulations, they can give rise to the appearance of a conflict of interest, as well as the potential for actual conflicts. The Institute therefore believes that it would be appropriate to tighten regulation in each of these areas.

1. Soft Dollar Arrangements Should Be Significantly Restricted

Section 28(e) of the Securities Exchange Act of 1934 provides a safe harbor that permits money managers, including advisers to mutual funds, to pay for brokerage and research services with client commissions, subject to various conditions. This section was enacted in 1975 in response to concerns that, with the unfixing of commission rates, money managers might be held liable if they paid more than the lowest possible commission rate and received these services.

Some assert that these arrangements may create incentives for advisers (1) to direct client brokerage to a broker-dealer based on the research services provided to the adviser rather than the quality of execution its clients' accounts will receive and/or (2) to pay too much in commissions or engage in unnecessary trading to generate soft dollars credits to pay for products and services that the manager might otherwise have to pay for from its own assets. To

reduce any such potential conflicts, the Institute recommends that the scope of the safe harbor under Section 28(e) be narrowed to exclude the following products and services:[34]

- Computer hardware and software, and other electronic communications facilities, used in connection with trading or investment decision-making;
- Publications, including books, periodicals, newspapers and electronic publications, that are generally available to the public; and
- Third-party research services, *i.e.*, research services that are not produced and provided by the broker-dealer effecting the securities transaction.[35]

This change would (1) ensure that the payment through commissions for products and services that have the attributes of traditional overhead and more routine expenditures of investment managers would fall outside of the safe harbor, and (2) limit the scope of the safe harbor to those research-related products and services that are produced by and provided directly by the broker-dealer receiving the commissions. Narrowing the safe harbor in this manner would be beneficial for investors because it would clarify application of the safe harbor in areas where guidance is needed; would make it easier for investors to understand the costs of

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[34] *See* Letter from Matthew P. Fink, President, Investment Company Institute, to The Honorable William H. Donaldson, Chairman, U.S. Securities and Exchange Commission, dated December 16, 2003 (recommending that the Commission adopt a revised interpretation under Section 28(e) of the Exchange Act to narrow the safe harbor in this manner) ("ICI Soft Dollars and Directed Brokerage Letter"). Some have suggested that Section 28(e) be repealed altogether to prohibit soft dollar arrangements. The Institute agrees that this is an issue that may warrant further study and consideration.

[35] This recommendation does not represent a judgment that proprietary research is somehow "better" than third-party research. It is, rather, based on the Institute's conclusion that there is no inherent reason why research provided by one firm should be bundled with execution services provided by a different firm. In contrast, where both types of services are provided by the same entity, allocating costs between the two can be difficult, particularly since brokerage firms do not typically break out such costs. The Institute believes that it is not necessary or advisable to delay soft dollar reforms that can be implemented relatively quickly while continuing to study the more complex issue of proprietary research. In my own view, to the extent that there already may be instances in which proprietary research and execution services are clearly severable, fund managers should pay for research services in hard dollars.

various investment advisory products, including mutual funds; would reduce incentives for money managers to engage in unnecessary trading; and would interpret Section 28(e) in a manner that is more consistent with its original purpose – a narrowly tailored provision that allows a money manager to take into account the intellectual resources, as well as the execution capabilities, of a brokerage firm in determining how to allocate trades.[36]

2. Directed Brokerage Arrangements Should Be Prohibited

The ability of fund advisers to take sales into account in allocating brokerage is strictly regulated under existing NASD rules.[37] The rules provide that a fund can only take a broker's sale of fund shares into account in selecting a broker if it is otherwise receiving best execution. In addition, the rules only permit funds to consider sales in allocating brokerage "after the fact;" conditioning fund sales on the payment of brokerage commissions is expressly prohibited. Notwithstanding the strict nature of these restrictions, this practice can give rise to the appearance of a conflict of interest, as well as the potential for actual conflicts, given the complexity of the best execution determination. For these reasons, the Institute urged the SEC to prohibit this practice.[38] The Institute is pleased, therefore, that the SEC recently proposed

[36] Because Section 28(e) is a safe harbor, failure to comply with its terms does not, in and of itself, violate any provision of law. For certain advisers, however, using commissions outside of the safe harbor raises serious issues under federal law. These include advisers to mutual funds and to pension plans under ERISA. In contrast, advisers to other types of accounts are not subject to similar substantive limitations. Instead, such advisers are only required to provide disclosure about their use of soft dollars in Form ADV. The Institute recommends that all investment advisers be prohibited from using brokerage commissions outside of the safe harbor to pay for any products or services used by the adviser. This change will extend the protections afforded to mutual funds and ERISA accounts to all investment advisory clients.

[37] *See* NASD Conduct Rule 2830(k).

[38] *See* ICI Soft Dollars and Directed Brokerage Letter, *supra* note 34. As part of its proposal, the Institute recommended that a safe harbor be adopted for funds that use brokers to execute portfolio transactions that also sell

amendments to Rule 12b-1 to address concerns with the use of brokerage commissions to pay broker-dealers for selling fund shares.[39]

B. 12b-1 Fees

In its release proposing amendments to Rule 12b-1 to prohibit directed brokerage arrangements, the SEC also requested comment on whether it should propose additional changes to Rule 12b-1 to address other issues that have arisen under the rule, or even propose to rescind the rule. The Institute agrees that, given the many developments in fund distribution practices since the rule was adopted in 1980, a reevaluation of the rule is timely and prudent. Due to the significance of the rule, its widespread use and related issues, it is important to solicit the views of all interested parties before determining whether further changes to the rule should be proposed. The Institute believes that Rule 12b-1 continues to have merit but that certain changes may be appropriate. We are in the process of developing our specific comments and look forward to providing them to the SEC. The use, disclosure and regulation of 12b-1 fees are discussed below.

1. 12b-1 Fees Expand Investor Choice and Align Financial Advisor and Shareholder Interests

shares of the fund in those cases where a fund has adopted policies and procedures reasonably designed to prevent sales from being considered in connection with brokerage allocation.

[39] *See* SEC Release No. IC-26356 (Feb. 24, 2004). The NASD also has proposed changes to its rules to prohibit directed brokerage. *See* Proposed Amendment to Rule Relating to Execution of Investment Company Portfolio Transactions, File No. SR-NASD-2004-027.

Innovations in mutual funds have given investors many choices about how and where they purchase mutual fund shares. Some investors prefer to buy mutual funds directly from the company sponsoring them. Others choose to purchase funds through brokers, financial planners, or other financial professionals who provide assistance and advice in selecting funds to help investors reach their long-term goals, such as retirement and education. The advisory relationship continues through the entire period of ownership, including the critically important withdrawal phase following retirement, during which fund shareholders need personalized advice to avoid either outliving their savings or compromising their lifestyles by under-spending.

Investment professionals traditionally were compensated for their services exclusively by an upfront sales commission, or "load," paid by investors when they purchased mutual fund shares. In 1980, the SEC adopted Rule 12b-1 under the Investment Company Act of 1940. The rule authorizes funds to use their assets to pay distribution costs. Although the rule initially was described by many as a way to help funds increase sales to offset net redemptions, the use of 12b-1 fees has evolved since the rule was adopted. Most significantly, it has provided a method for tying the payment stream to the length of the advisory relationship, rather than compensating the advisor only with a single, upfront payment. Shifting all or a portion of the advisor's compensation from upfront, transaction-based commissions to an ongoing fee for maintaining the relationship aligns the interests of the advisor and the shareholder, eliminating the situation where the only way to get paid is to churn the account, and allows compensation to continue into the critical withdrawal period when no new purchases are being made. Many funds now offer various classes of shares that invest in the same portfolio of securities but provide a variety of different expense and advisor compensation options, allowing choice as to

which one best reflects the nature of the relationship.[40] Different classes may be sold through different distribution arrangements (*e.g.*, retail broker-dealers, employer-sponsored retirement plans, etc.) and may have different expense levels that reflect their customization.

Most investors use the services of a financial intermediary; thus, most funds have sales charges and ongoing fees to cover these costs. Importantly, investors are well aware of the option of purchasing funds directly without paying for the services of a personal advisor; many choose to do so while the majority prefer to use an advisor. Indeed, Institute data show that among shareholders holding funds outside defined contribution plans, more than 70 percent primarily purchase funds through financial advisors and other intermediaries.[41] In other words, in many cases, investors are receiving professional advice or other services from financial intermediaries when investing in mutual funds; Rule 12b-1 has made it possible for funds to provide investors with a choice of how and when to pay for these services.

The Institute recently undertook a study of mutual fund distribution channels and trends in distribution costs since 1980.[42] The study found that changes in fund distribution over the last 25 years have been accompanied by a significant decrease in the average cost of distribution services incurred by mutual fund buyers. The average annual distribution cost

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[40] Institute research indicates that each of these options can be optimal for particular investors, depending on the expected time horizon of their investment (including whether they are uncertain about the length of their holding period) and the amount invested. *See* Brian K. Reid and John D. Rea, "Mutual Fund Distribution Channels and Distribution Costs," *Perspective*, Vol. 9, No. 3, July 2003, at 11-13, available at http://www.ici.org/stats/res/per09-03.pdf. For purposes of the study, distribution costs were defined as charges incurred by mutual fund investors directly through the payment of sales loads or indirectly through 12b-1 fees.

[41] *See* Investment Company Institute, 2001 Profile of Mutual Fund Shareholders, at 68.

[42] *See* Reid and Rea, *supra* note 40.

incurred by buyers of equity funds decreased from 1.49 percent (or 149 basis points) of their initial investment in 1980 to 40 basis points in 2001 – a 73 percent decrease. Similarly, distribution costs of bond funds fell 60 percent, from 82 basis points in 1980 to 33 basis points in 2001.[43]

2. <u>12b-1 Fees Are Fully Disclosed</u>

Assertions that 12b-1 fees are "hidden costs" are completely without merit. All mutual fund fees and expenses are fully disclosed in a standardized fee table that is required to be at the front of a fund's prospectus. If a fund has a 12b-1 fee, it will be clearly identified as a separate line item in the fee table as part of the fund's annual operating expenses. In addition, it is reflected in the fund's total annual operating expenses shown in the fee table and in the hypothetical example of fund expenses that accompanies the fee table.

Investors also can determine whether a fund charges a 12b-1 distribution fee by reviewing the mutual fund listings published in most newspapers. A newspaper's listings offer information about a fund's fees by using a series of symbols next to the fund's name. A fund that has a 12b-1 fee will have the letter "p" next to its name in the newspaper.

In addition to disclosing the fact that a fund has a 12b-1 fee, such funds are required to include disclosure in the prospectus concerning the impact of this ongoing fee. Specifically, the

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[43] According to the Institute's study, these declines were due to several developments, including growth in sales through 401(k) plans, which have lower distribution costs, and increased competition from no-load funds. *Id.* at 16-17.

prospectus must disclose that over time, 12b-1 fees will increase the cost of an investment in the fund and may cost the investor more than paying other types of sales charges.[44]

The SEC has proposed new requirements under which broker-dealers would have to make additional disclosures to investors before they purchase mutual fund shares.[45] Such disclosures would include the estimated amount of 12b-1 fees to be paid in the year following purchase, if the fund's net asset value remained constant. The SEC's proposal also would require quantitative disclosure of 12b-1 fees on mutual fund confirmations. The Institute supports requiring such disclosure.

3. Substantive Regulation of 12b-1 Fees Further Protects Fund Investors

In addition to the wealth of information about fees and expenses that is available to mutual fund investors and their professional advisors, there are a number of substantive regulatory protections that apply to mutual fund fees, including in particular 12b-1 fees.

First, NASD rules place limits on all mutual fund sales charges, including "asset-based sales charges" (12b-1 fees).[46] In addition, a fund that has a front-end or deferred sales charge, or

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[44] Additional, more detailed disclosure about a fund's 12b-1 fee is required in the Statement of Additional Information, which is available to fund shareholders free of charge upon request. Such disclosure includes, among other things, a breakdown of the dollar amount of 12b-1 payments made for various activities, such as advertising and compensating broker-dealers.

[45] *See* SEC Release No. IC-26341 (Jan. 29, 2004).

[46] *See* NASD Conduct Rule 2830. NASD rules limit total front-end and/or deferred sales charges to no more than 8.5% of the offering price, although most funds charge far less than the maximum. The rules also limit 12b-1 fees. These fees are limited to a maximum of 1.00 percent of the fund's average net assets per year, which may include a service fee of up to 0.25 percent to compensate intermediaries for providing services or maintaining shareholder

a 12b-1 fee higher than 25 basis points, cannot be referred to as a "no load" fund.[47]

Second, fund boards of directors oversee all expenses and have specific review, approval and oversight responsibilities with respect to any 12b-1 fee.

Any payments by a fund pursuant to Rule 12b-1 must be in accordance with a written plan approved annually by the fund's board of directors, including a majority of the independent directors. The fund's directors must review, at least quarterly, the amounts spent under a 12b-1 plan and the reasons for the expenditures.[48]

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accounts. NASD rules also subject the aggregate amount of 12b-1 fees to a lifetime cap, based upon a percentage of fund sales. These limits appropriately treat 12b-1 fees, in effect, as an alternative form of sales charge.

In addition to these fee limits, NASD rules impose suitability requirements on broker-dealers with respect to securities that they recommend, including mutual funds. The NASD has provided guidance reminding its members that, in determining the suitability of a particular fund, a member should consider the fund's expense ratio and sales charges as well as its investment objectives. The NASD also has issued specific guidance concerning the application of suitability principles to sales of mutual funds that offer multiple classes. *See, e.g.,* NASD Regulation, Inc., "Suitability Issues for Multi-Class Mutual Funds," Regulatory & Compliance Alert, Summer 2000, available at http://www.nasdr.com/rca_summer00_reg.htm#suitability.

[47] NASD rules permit funds with a 12b-1 fee of no more than 25 basis points to be designated as "no load" funds in recognition that the expenses of funds with a low 12b-1 fee tend to more closely resemble those of funds with no sales charges or 12b-1 fees.

[48] Some have questioned the propriety of funds that are closed to new investors continuing to pay 12b-1 fees. According to Institute data, most 12b-1 fees are used to compensate financial advisors for providing assistance to investors in selecting mutual funds or to compensate financial advisors for providing ongoing services to existing fund shareholders. The fact that a fund may have stopped selling shares to new investors is irrelevant to existing shareholders; it does not make it improper or unnecessary for existing shareholders to continue to pay for these services. Also, it would be both disruptive and inappropriate for funds to cease 12b-1 payments in many cases; for example, where a fund underwriter "fronts" money to salespeople with the expectation that these expenditures will be recouped through the 12b-1 fee over time. In these circumstances, the payments compensate the fund's distributor for its past distribution efforts. Finally, as noted above, the NASD imposes limits on 12b-1 fees that are tied to a fund's overall sales of shares. A fund that stops selling shares will eventually reach its "cap" and have to cease imposing asset-based sales charges under Rule 12b-1.

In addition to the specific limits on fund fees and the board review, approval and oversight requirements described above, another level of investor protection is provided through requirements that shareholders must approve any material increase in a fund's 12b-1 fee. Thus, funds cannot unilaterally raise 12b-1 fees, nor may the board alone approve a fee increase.

C. Revenue Sharing Arrangements

As discussed above, mutual fund investors currently have choices in the manner and timing of payments to compensate investment professionals for the services they provide (*i.e.*, through sales charges, 12b-1 fees or, most frequently, a combination). Competition among funds for the services of selling intermediaries (*e.g.*, broker-dealers) has led these intermediaries, however, to seek additional compensation, or cost sharing, for distributing fund shares and providing services to shareholders. Consequently, it is common practice in the fund industry for fund investment advisers or principal underwriters to enter into so-called "revenue sharing" arrangements, under which the adviser or principal underwriter makes payments out of its own resources to intermediaries who sell fund shares. In fact, I believe these arrangements are more accurately described as cost-sharing arrangements.

The principal investor protection concern raised by these payments is whether they have the potential for influencing the recommendations of the financial intermediary that is receiving them.[49] Disclosure concerning the payments is already required in fund prospectuses, and the

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[49] Legislation currently pending before Congress contains a provision that would impose a fiduciary duty on fund directors to determine that any revenue sharing arrangements are in the best interests of fund shareholders. *See, e.g.*, H.R. 2420 and S. 1971, *supra* note 33. Such a requirement is misguided. The directors are responsible for overseeing uses of the fund's assets. These arrangements, by definition, do not involve the use of fund assets. Indeed, if any payments are made directly or indirectly by a fund, they must comply with Rule 12b-1. H.R. 2420 and S. 1971 would address any possible concern that revenue sharing arrangements may involve an indirect use of fund assets by requiring fund directors to review revenue sharing arrangements to ensure that they comply with the Investment Company Act of 1940. Fund directors play an important role in overseeing the adviser's overall distribution practices but they should not be expected to review individual agreements or arrangements with intermediaries that sell fund shares.

Institute has long advocated additional, point-of-sale disclosure by broker-dealers to help investors assess and evaluate recommendations to purchase fund shares.[50]

As noted above, the SEC recently proposed new point-of-sale and mutual fund confirmation statement disclosure.[51] The proposed disclosure would address, among other things, payments by fund sponsors for brokers to sell particular funds.[52] Under the SEC's proposal, broker-dealers would be required to disclose to customers, prior to a purchase of mutual fund shares, whether they receive such payments, and whether the broker-dealer pays differential compensation in connection with transactions in shares of the fund.[53] The Institute strongly supports this aspect of the proposal. The SEC's proposal also would encompass other sales-related fees and payments, such as upfront and deferred sales charges and 12b-1 fees. The Institute supports requiring point-of-sale disclosure of such fees and payments.

D. Additional Disclosure Initiatives

Many of the proposed reforms discussed above would involve providing new or enhanced disclosure to investors. The SEC has long recognized the challenge of designing

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[50] *See, e.g.*, Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Ms. Joan Conley, Office of the Corporate Secretary, NASD Regulation, Inc., dated Oct. 15, 1997.

[51] *See supra* note 45.

[52] *See* SEC Release Nos. 33-8358; 34-49148; IC-26341 (January 29, 2004). The NASD also has recently proposed new point of sale disclosure concerning revenue sharing and differential cash compensation arrangements. *See* NASD Notice to Members 03-54 (September 2003), available at http://www.nasdr.com/pdf-text/0354ntm.txt. The Institute supports the NASD's proposal. *See* Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Barbara Z. Sweeney, NASD, Office of the Corporate Secretary, dated Oct. 17, 2003.

[53] We note that broker-dealer recommendations to customers to purchase fund shares also must comply with NASD suitability requirements.

disclosure that is comprehensible, informative and useful to the average fund investor. With its 1998 overhaul of mutual fund prospectuses and adoption of "plain English" requirements, both of which the Institute supported, the SEC made significant strides in this direction. These major initiatives transformed fund prospectuses, making them significantly more informative and "user-friendly" than they had been previously.

Nevertheless, it is axiomatic that efforts to improve disclosure of important information to fund investors must be ongoing. The SEC and the industry share a common interest in seeking to assure that investors fully understand their fund investments. As part of its continuing efforts to provide mutual fund investors with useful information, particularly information concerning fund fees and costs, the SEC has recently adopted, proposed, and issued a concept release on new or improved disclosure in the following areas.

1. Portfolio Holdings and Expense Disclosure

Last month, the SEC adopted a proposal that requires funds to disclose their portfolio holdings on a quarterly (rather than semi-annual) basis, and makes other changes to disclosure in fund shareholder reports.[54] As part of the new requirements, funds will have to disclose in their shareholder reports the dollar amount of expenses paid on a $1,000 investment in the fund during the period covered by the report. The Institute supports this disclosure, which will supplement the detailed fee disclosure currently required in fund prospectuses. It will serve to remind investors about the impact of fund expenses. Importantly, it will do so in a format that

[54] *See* SEC Release No. IC-26372 (February 27, 2004).

permits investors not only to readily estimate their own expenses but also to compare the expenses of different funds.

In adopting this proposal, the SEC expressed its continued belief that disclosure of current period expenses in fund shareholder reports strikes an appropriate balance between investors' need for this information and the costs and burdens that would be associated with providing the information on an individualized basis (*e.g.*, in quarterly account statements). The SEC noted that its approach avoids the substantial costs and logistical complexity that would be associated with requiring individualized expense disclosure in quarterly account statements. Such costs and complexity result from: (1) the need for funds to make systems changes to compute and disclose individual account expenses for those accounts for which the fund knows the ultimate account owner; (2) the need for funds to make the necessary systems changes to provide to thousands of third-party intermediaries the information they will need to compute and report the expense information for those accounts as to which only the intermediary knows the ultimate account owner (*e.g.*, omnibus accounts); and (3) the need for third-party intermediaries that prepare account statements to implement new systems that would allow them to calculate and report personalized expense information for each fund held in an account in an accurate and timely manner.

In the context of discussions of disclosure of fund expenses, another approach that has been suggested is to provide estimates of individualized expenses in quarterly account statements. The estimated expense amounts would be calculated based on the assumption that the fund holdings of each shareholder remained the same throughout the quarter.

The Institute believes it would be inappropriate to mandate this form of expense disclosure across the entire industry. Importantly, although providing estimated expense information would eliminate some of the costs and complexities noted above by making it unnecessary to calculate expenses at the shareholder account level on a daily basis, accuracy and precision would be sacrificed. It would seem odd if a regulatory regime under which funds must price their shares at a value that is accurate to one penny simultaneously required expense disclosure that could be inaccurate by a significant order of magnitude due to assumptions made to simplify the calculation. Moreover, requiring estimated expense disclosure in account statements would still entail the most significant costs and complexities referred to above, which are those involved in ensuring that the thousands of intermediaries who prepare account statements for fund investors get, and are able to integrate and report, the necessary data from many unrelated fund groups.

The high costs and complexity of implementing the two forms of individualized expense disclosure described above (and the lack of precision of estimated expense disclosure) are not their only drawbacks. Both would sacrifice a key benefit of the approach adopted by the SEC: the ability of investors to compare the expenses of different funds. The Institute agrees with the SEC that the approach it has chosen strikes the best balance and notes that it is the only one that preserves comparability.

The Institute believes that the new expense disclosure in fund shareholder reports should be given a chance to work. Although we continue to have serious reservations about requiring individualized expense disclosure in account statements for the reasons discussed

above, if there are other ways to further enhance disclosure of fund fees and expenses at a reasonable cost, we would support pursuing them.

2. Sales Charge Breakpoints

Many mutual funds that are sold with front-end sales charges offer discounts to investors who invest specified amounts of money. The investment levels at which investors qualify for the discounts are called "breakpoints." In late 2002 and early 2003, regulatory investigations revealed instances in which investors did not receive the benefit of sales charge reductions to which they were entitled. Most of these situations did not appear to involve intentional misconduct. These examination findings led to the formation of a Joint NASD/Industry Breakpoint Task Force, made up of high-level NASD, mutual fund and broker-dealer representatives. The Task Force issued a report in July 2003 making a series of recommendations designed to ensure that processes are in place so that investors will receive applicable discounts.[55] These recommendations include additional required disclosure concerning breakpoint discounts. The SEC recently proposed amendments to fund prospectus disclosure requirements to improve disclosure concerning sales charge breakpoint discounts.[56] The Institute supports this proposal.[57]

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[55] Report of the Joint NASD/Industry Task Force on Breakpoints (July 2003).

[56] *See* SEC Release No. IC-26298 (December 17, 2003).

[57] *See* Letter from Tamara K. Salmon, Senior Associate Counsel, Investment Company Institute, to Mr. Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission, dated February 5, 2004.

3. Portfolio Transaction Cost Disclosure

In December 2003, the SEC issued a concept release seeking comment on how to improve disclosure concerning funds' portfolio transaction costs.[58] The SEC's release acknowledged the many issues involved in quantifying these costs and providing disclosure that would assist investors in understanding these costs. The Institute filed a comment letter in which it recommended, among other things, enhanced disclosure concerning brokerage commissions, fund flows and portfolio turnover to heighten investors' awareness of portfolio transaction costs and their impact on fund performance.[59] The Institute's letter opposed requiring funds to quantify all portfolio transaction costs and include them in the expense ratio or fee table, due to concerns that such a requirement would call for disclosure that would be misleading, rather than helpful, to investors.[60]

VI. CONCLUSION

I appreciate the opportunity to provide testimony to the Committee on behalf of the Institute on the foregoing matters. The industry remains committed to working with the Committee and regulators to take the steps necessary to make sure that the interests of fund investors are protected and served.

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[58] *See* SEC Release No. IC- 26313 (December 18, 2003).

[59] *See* Letter from Amy B.R. Lancellotta, Senior Counsel, Investment Company Institute, to Mr. Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated February 23, 2004. The Institute also recommended enhanced board oversight of portfolio transaction costs.

[60] As noted in the Institute's comment letter, there is no single, agreed-upon measure of transaction costs (nor is there necessarily agreement on what the components of such costs are). Although commissions can be measured directly, other types of transaction costs, such as spread costs and market impact costs, cannot. Existing measures that funds use for internal purposes all have significant limitations that would make them unsuitable for disclosure to investors. For example, some measures do not include all of the components of transaction costs and would therefore present an incomplete picture of these costs to investors.

PREPARED STATEMENT OF CHET HELCK

PRESIDENT, RAYMOND JAMES FINANCIAL, INC.

MARCH 31, 2004

Introduction

Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee. I am honored to address the Senate Banking Committee concerning a subject that I believe is crucial to the welfare of American investors and our Nation's securities markets, as well as the industry and regulators who support these markets.

I am Chet Helck, the President and Chief Operating Officer of Raymond James Financial. Raymond James provides financial services to individuals, corporations, and municipalities through its 5,000 financial advisors throughout the United States and internationally. I am also privileged to represent my firm on the Board of Directors of the Securities Industry Association (SIA) and to testify today on behalf of Raymond James and on behalf of SIA.[1]

While I represent a securities firm that serves hundreds of thousands of investors, I am also speaking to you as an experienced financial advisor who has spent more than 20 years providing counsel and services to help individuals take care of their families and realize their financial objectives. Through these experiences, I have witnessed the dramatic impact that knowledgeable advisors who are supported by effective resources can make on their clients' lives. My experience has taught me full-well that investors' trust and confidence is a hard-earned, precious, and essential asset, on which our business is built. Abuses that undermine investor trust and confidence must be met with tough and firm regulatory action. At the same time, my perspective makes me concerned that proposed mutual fund reforms not have unintended consequences that could ultimately degrade the infrastructure that makes it possible for these relationships to thrive—to the detriment of the investing public, and particularly the small investor.

Importance of Professional Advice to the Investing Public

Most Americans realize that they can no longer depend on one lifelong job or an employer's pension to provide them with a secure retirement. They know that they must develop meaningful savings during their working days and then establish an investment plan to create a revenue stream to sustain them over retirement. Planning for education and health care costs represents similarly daunting financial challenges. For most of us, even if there were no other mitigating factors complicating these planning processes, creating these types of investment plans would be overwhelming.

It is against this backdrop that I suggest that most Americans need financial advice more than ever before. Indeed, many investors have learned to truly value professional financial advice during these difficult times. Even some securities firms that traditionally served only self-directed investors have recently recognized this need and established lines of business to provide advice.

I believe that our current system, which provides investors with the ability to engage professional advisors for financial guidance, works well for millions of Americans and I also believe that mutual funds play a critical role in the financial plans of millions. For that reason, we should all be concerned about instances of illegal conduct occurring in some funds. For the same reason, it is important that proposals for fundamental changes to this system avoid unintended consequences that could harm individual investors and also weaken the financial markets that help make our free enterprise economy so strong.

In my capacity as a member of SIA's Board of Directors, I appreciate that many SIA member firms follow a different business model, encouraging investors to make investment choices on their own. I respect that alternative and certainly believe in competition—that is the American way. But my own career and my firm are dedicated to the idea that financial consultants can add great value by helping investors make intelligent choices when confronted with so many investment alternatives.

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[1] The Securities Industry Association, established in 1972 through the merger of the Association of Stock Exchange Firms and the Investment Bankers Association, brings together the shared interests of nearly 600 securities firms to accomplish common goals. SIA member-firms (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs more than 800,000 individuals. Industry personnel manage the accounts of nearly 93 million investors directly and indirectly through corporate, thrift, and pension plans. In 2002, the industry generated $222 billion in domestic revenue and $304 billion in global revenues.

Mutual Funds and the American Investing Public

The focus of your deliberations is the compensation structure for the services associated with selling mutual funds, and the advisory and administration services required to support investors in the purchase of mutual funds. We believe that mutual funds are, and will continue to be, a basic investment vehicle for most Americans. In spite of the barrage of recent bad press concerning these investments, mutual funds are the vehicle by which an overwhelming majority of investors participate in our markets. Mutual funds offer investors an inexpensive way to share in the benefits of owning stocks and bonds and a method for diversifying a relatively small investment, thereby managing their risk exposures. And they allow investors to benefit from professional management of their invested dollars. For these reasons, mutual funds are extremely popular products for small investors, as well as for retirement plans such as 401(k) plans.

Overall, 49.6 percent of all households in the United States own mutual funds directly or through a retirement account.[2] As of January 2002, 89 percent of U.S. equity investors owned stock mutual funds, and 51.5 percent of equity investors held stock only mutual funds.[3] Twenty-six percent of all household liquid financial assets were in mutual funds as of the end of 2003.[4]

The health of our capital markets depends to a great extent on the public's continued robust participation in mutual funds. As of January 2004, equity mutual funds had a market capitalization of $3.8 trillion dollars, roughly 25 percent of the total capitalization of our equity markets.[5]

Retail investors put their trust in the integrity of mutual fund managers and advisers, as well as in the financial advisors who assist in their investment decisions and the broker-dealers that implement their trade orders. It is certainly troubling that recent events have severely damaged the reputation of mutual funds and their management companies, as well as those who participate in their distribution. I know that all of us in the industry firmly believe that abuses such as insider trading should be rooted out and punished wherever it occurs—whether at high profile public companies, at broker-dealers, or at mutual funds. Abuse of fiduciary responsibilities should be condemned and, where appropriate, punished. And we also recognize that, as I shall discuss in a few moments, better disclosure of mutual fund compensation practices can be helpful to investors and should be required.

In order to restore public trust and confidence in mutual funds and their distributors, the interests of investors must come first. Investors must be assured that fraud, self-dealing, and dishonesty will not be tolerated. Investors should be treated fairly, and should be given clear and useful information about the funds they buy. Fund fee structures, financial support offered to intermediaries, fund investment, and redemption policies—all should be as transparent and meaningful as possible. When an investor seeks investment advice, the financial advisor should recommend mutual funds that are suitable in light of an investor's objectives. And all investors should be assured of prompt execution and fair pricing of their mutual fund transactions.

But public trust is a fragile thing. This Committee, and the regulatory community, can either work to restore it—or can diminish that public confidence even further by actions that ultimately detract from that trust. We are confident that this Committee, along with other policymakers, will choose wisely and strengthen the viability of these products and the vital distribution systems that bring them to investors' doorsteps. The recent scandals have presented a serious challenge to all of us who believe that funds serve investors well. We must face these challenges forthrightly and seek thoughtful and workable solutions that will protect investors' interests. This Committee and the regulatory community must help restore public confidence by rooting out instances of wrongdoing, without diminishing the basic value of mutual funds or of the advisory structure that has grown up around it. Because mutual funds are good investment planning solutions for most Americans—particularly those who are of modest means—anything that unfairly undermines their confidence in funds or makes it more difficult to provide meaningful advice concerning them would be a disservice to the investing public.

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[2] *http://www.sia.com/research/pdf/equity__owners02.pdf.*

[3] *Id.*

[4] *http://www.federalreserve.gov/releases/Z1/Current.*

[5] For equity market capitalization (combined New York Stock Exchange and Nasdaq) *see http://www.nyse.com/pdfs/mmv1204.pdf; http://www.marketdata.nasdaq.com/daily/daily 2004.xls;* For mutual fund data *see http://www.ici.org/stats/latest/trends__01__04.html#TopOf Page.*

Compensation for Mutual Fund Sales

As with any product, there are costs associated with distributing and servicing mutual funds. As mutual funds types have proliferated—a result of vigorous competition and innovation—selling arrangements for funds have expanded as well. Because selling arrangements have raised particular concerns, we address several aspects of these arrangements.

Forms of Compensation

Broker-dealers receive payments in connection with sales of mutual funds, unit investment trusts, municipal fund securities, variable annuity contracts, and variable life insurance policies (collectively, funds) from a variety of sources. Some payments are made by the funds themselves or by investors when they buy or sell fund shares. Other payments may be made by investment advisers, fund distributors, or other fund affiliates; and some broker-dealers charge investors directly for their services through the medium of fee-based accounts.

In addition to these various sources, broker-dealers may receive payments in several different ways. Some payments may represent hard-dollar payments from funds and investors (encompassing sales loads and 12b–1 fees). Other payments may represent hard-dollar payments from fund affiliates (commonly known as revenue sharing). Still other payments may be made in the form of commission payments on fund portfolio brokerage transactions (often referred to as directed brokerage).

Some observers believe that fund payments, directed brokerage, and revenue sharing are simply "taxes" that broker-dealers impose upon funds and their affiliates, and that all such payments go straight to the broker-dealers' bottom lines. However, these arrangements are necessary to enable broker-dealers to support the administrative costs associated with fund sales and investor reporting, and provide more comprehensive investor services such as financial planning, total portfolio review, and performance reporting that investors have come to expect.

In recent years, broker-dealers have been handling functions that mutual fund organizations previously might have performed exclusively. This shift in function has provided many operating efficiencies and benefits to investors, including consolidation of investments within a single financial services organization, and easier access to investment services. Revenue-sharing payments often help reimburse broker-dealers for some of the following expenses associated with processing fund transactions and maintaining customer accounts:

- Customer sub-accounting.
- Mailing trade confirmations, prospectuses, and other disclosure documents.
- Comprehensive tax reporting.
- Maintaining information websites.
- Implementing changes initiated by funds, including revising systems and procedures and communicating changes to financial advisors and customers.
- Overseeing and coordinating fund wholesaler activities at the firm.

To the extent that the services are performed by the broker-dealer, instead of the fund, investors are not paying more. For example, there is a cost to maintaining an accurate shareholder record—whether the fund's transfer agent performs that function or the fund delegates that responsibility to the broker-dealer.

In addition, broker-dealers use revenue-sharing payments to fund other activities, such as educational seminars for their financial advisors and their clients about the different funds they consider. These activities make the financial advisors more knowledgeable about the funds and can help them tailor their recommendations more effectively. SIA members offer a broad spectrum of fund choices—ranging from offering perhaps a few families of funds to thousands of different share classes. But regardless of how many mutual funds a broker-dealer sells, it is in investors' best interest if the broker-dealer's financial advisors are well acquainted with those funds and can help their customers choose wisely. Revenue sharing contributes significantly to that goal.

12b–1 Fees

The SEC adopted Rule 12b–1, which permitted mutual funds to use their assets to pay for distribution, as long as the fees were disclosed and regulated.[6] Since Rule 12b–1 was adopted, more than half of all mutual funds have enacted Rule 12b–1 plans, using these charges, alone or with sales loads, as the primary means of fi-

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[6] SEC Division of Investment Management, *Protecting Investors: A Half Century of Investment Company Regulation,* at 322 (1992) (Protecting Investors Study), citing SEC Division of Investment Management, *Regulation, Mutual Fund Distribution, and Section 22(D) of the Investment Company Act of 1940,* at 19, 20–22 (1974) (1974 Distribution Report).

nancing distribution.[7] Other mutual funds have added a relatively modest Rule 12b–1 fee to pay for some sales commissions, printing prospectuses and sales literature, advertising, and similar expenses.[8] It is important to note that while Rule 12b–1 was intended to assist no-load mutual funds to finance their distribution expenses, the vast majority of load mutual funds have adopted Rule 12b–1 plans as a complement to, or a substitute for, a front-end sales load.

The impact of these fees has been positive. They have allowed funds to reduce front-end sales charges. They have contributed to development of longer holding periods and a more stable investment profile for clients. And, because they are paid over an extended period of time, they promote a continuing relationship, encouraging the financial advisors to offer continued service over a period of time.

Mutual Fund Share Classes

Sometimes lost in the discussion of mutual fund fees is the fact that the fund industry also created a number of share classes. The wide variety of share classes available today affords investors a variety of options for compensating advisors for their services. Advisors and clients can select fund classes to establish a compensation arrangement that is consistent with clients' objectives, time horizons, and personal preferences. Each class of a multiple class fund must have a different arrangement for shareholder services or distribution or both, and must pay all of the expenses of that arrangement. Some multiple class funds enter into arrangements whereby particular classes of fund shares are sold to specific institutional investors, such as banks acting in a fiduciary, advisory, agency, custodial, or similar capacity on behalf of customer accounts, insurance companies, investment counselors, brokers, or other financial institutions.[9]

Multiple class funds also permit investors to select the method of financing distribution best suited to their investment horizon and the size of their investment.[10] Some investors may wish to pay a front-end sales load, whereas others may wish to avoid paying a front-end sales load, and are willing to pay a Rule 12b–1 fee and contingent deferred sales charge (CDSC) instead.[11]

As the type and level of mutual fund charges began to change, the NASD revised its rules governing the level of mutual fund sales loads and distribution fees to provide consistency of approach and fairness to investors (NASD Conduct Rule 2830(d)).

Brokerage and "Soft-Dollar Payments"

When Congress enacted Section 28(e) of the Securities Exchange Act of 1934, it recognized the need for money managers to obtain research from a wide range of sources. Section 28(e) permits money managers to pay for research and related services through commission (soft) dollars rather than paying for them in cash. Such research helps money managers, including fund managers, do a better job of serving their customers.

Eliminating this source of research dollars would be contrary to investors' interests. Research improves the quality of markets by helping money managers channel capital to the most promising companies. Research analysts challenge companies to explain their business models and their record of results. Reducing research dollars would mean the elimination of research on certain types of companies. Reducing research dollars could therefore adversely affect the ability of smaller, newer companies to obtain financing for their activities. We all know that new businesses create the most jobs in America; raising their cost of capital hurts everyone.

Some have urged that research is not a legitimate expense for investors to bear through "soft-dollar" payments made in the form of trades placed by broker-dealers on behalf of the fund company. Over the years, the SEC has monitored the use of soft dollars by the industry. We believe that few abuses have been found and, in general, soft dollars have proved to be proinvestor and procompetitive, because they

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[7] Protecting Investors Study, at 320.
[8] *Id.*
[9] *See Id.,* at 330.
[10] *Id.,* at 331.
[11] A CDSC is a sales load paid by investors upon redemption that declines over the period of a shareholder's investment. So-called B shares typically feature a combination of Rule 12b–1 fees ranging from 0.50 percent to 1.00 percent of the average daily net assets of a mutual fund attributable to the B shares (annualized), and CDSC's in lieu of front-end sales loads, while so-called A shares typically feature front-end sales loads and Rule 12b–1 fees of no more than 0.25 percent of the average daily net assets of the mutual fund attributable to the A shares (annualized). However, the NASD has taken enforcement actions against broker-dealers who have sold B shares to individuals in instances in which A shares would have been an economically superior investment. *See, for example,* McLaughlin, Piven, Vogel Securities, Inc. (MPV) (press release available at *http://www.nasdr.com/news/pr2003/release_03_027.html*).

increase competition among money managers, encourage independent research, and give investors more choices.

We believe that research, whether from the broker-dealer, or a third party, contributes to the effort to identify better investments. Third-party research is a valuable resource to money managers because it provides managers with ideas and insights that otherwise might be overlooked; and any ban on soft dollars is likely to diminish independent research.[12] Consequently, we believe that any movement to abolish soft dollars or to prohibit the use of soft dollars to obtain independent research would adversely affect the quality of the research available to money managers, which would ultimately harm investors.[13]

Raymond James and its Mutual Fund Expenses

Let me give you some examples of what costs are supported at Raymond James. At Raymond James, we sell over 11,000 mutual fund share classes, offered by over 200 fund companies. During fiscal year 2003, the total cost to our firm for providing the administrative support for mutual fund sales was approximately $30 million. These payments also help fund our Mutual Fund Research Department, which analyzes the universe of mutual fund offerings to generate a recommended list of mutual funds that we consider to have superior prospects. And that list has nothing to do with our receipt of "revenue sharing" payments; there are mutual funds on that list from whom we receive no payments, and there are funds from which we receive payments that are not on that list.

In addition to administrative support and research, we are required to provide educational programs for our financial advisors to help them deal with the complexities and regulatory requirements involved in making effective use of mutual funds in client financial planning. During the past 12 months, on major regional and national educational conferences we spent well over $7 million. Many of the sessions in these conferences qualified for continuing education credit by regulators, CFP and CPA societies and others. These are serious substantive courses that improve the effectiveness of our financial advisors and better equip them to help clients face the issues that they must face.

All of these costs and programs are supported by the payments that we receive from mutual fund companies and their managers in all the forms that we have discussed: Sales loads, revenue sharing, and directed brokerage. In our view, it is entirely reasonable that the fund complexes sponsoring these mutual fund families should help defray the expense of educating our financial advisors about their particular products. The net result of this effort is that our financial advisors have a much deeper understanding about the products that they sell and can be of much greater help to their clients in making investment choices. Why would anyone want to dismantle a system that provides such advantages to investors?

Full Disclosure—But Meaningful and Cost-Effective Disclosure

The Securities and Exchange Commission has proposed new confirmation rules that would require brokers, dealers, and municipal securities dealers to provide customers with information about distribution-related costs that investors incur when they purchase those types of securities, as well as disclosure of other distribution-related arrangements. Furthermore, it has proposed new point-of-sale disclosure rules that would require brokers, dealers and municipal securities dealers to provide point-of-sale disclosure to customers about costs and conflicts of interest.[14] (The SEC has also proposed rule amendments that would prohibit funds from using portfolio brokerage commissions to pay for the cost of distributing their shares.[15])

Raymond James has been an industry leader with respect to client disclosure of mutual fund sales and compensation.[16] Our long-form confirmation discloses a comprehensive range of relevant information, including many items currently being proposed by the SEC. These include:

- How the sales charge was computed.

[12] We note that one objective of last year's global research settlement was to require investment banks to fund independent research.

[13] Market forces also may affect how investment advisers buy execution and research services from broker-dealers and third-party providers.

[14] *Confirmation Requirements and Point-of-Sale Disclosure Requirements for Transactions in Certain Mutual Funds and Other Securities, and Other Confirmation Requirement Amendments, and Amendments to the Registration Form for Mutual Funds,* Release Nos. 33–8358; 34–49148; IC–26341; *http://www.sec.gov/rules/proposed/33–8358.htm.*

[15] *Prohibition on the Use of Brokerage Commissions to Finance Distribution,* Release No. IC–26356; *http://www.sec.gov/rules/proposed/ic–26356.htm.*

[16] SIA notes that many firms take different approaches to disclosure and we do not mean to suggest that other approaches are inadequate.

- Information regarding possible discounts to which the customer may be entitled.
- Information regarding other available sales classes.
- The fact that Raymond James may be receiving compensation in the form of revenue sharing from the fund or its management company.

In addition, ever since 1994, Raymond James has produced a pioneering document entitled "Your Rights and Responsibilities as a Raymond James Client." Each client receives one, and it is available on our website. There, we provide additional comprehensive information regarding how mutual funds are distributed, the different options for purchase, and the existence of revenue sharing arrangements that result in payments to Raymond James.

It is from this perspective that we are comfortable in supporting clear, concise, and meaningful disclosure of compensation practices, including those we have discussed in this paper. The SEC has proposed such disclosure and we, along with others in the industry, will be submitting our thoughts as to how these disclosures can be made meaningful and useful, without at the same time imposing excessive costs on the industry, costs which are ultimately borne by the investing public.

Briefly, we believe that additional disclosure to investors about revenue sharing is useful; but we believe that there are better ways to provide relevant information without imposing excessive costs that investors ultimately have to bear—and without distracting them from other important information. Raymond James, along with other firms and SIA, are busy working on our suggestions for improvement, so I cannot give you all our comments right now—the proposal runs to over 120 pages with over 200 footnotes. But from Raymond James's perspective, we would like to make two suggestions regarding this proposal:

1. It is time for the SEC to move away from paper disclosure—the proposal itself indicates the annual printing costs will add more than a billion dollars a year to the cost of mutual fund sales, ultimately to be borne by the investors. Let us enter the 21st century and put as much as possible of the important disclosures on our websites, where investors can access them readily—and have our confirmations refer the investors to our websites. For those clients who do not have computer access, our confirmation forms can give them the phone number to request a copy of the information on the website.
2. Don't require transaction-by-transaction breakdown of revenue sharing payments—it would require extraordinary programming costs that again would be borne by investors. Instead, let us use hypothetical examples of the costs that would be borne by investors at different purchase levels: say $10,000, $50,000, and $100,000. That should be enough to give every purchaser a sense of the impact on his investment of these costs.

I am sure that we will have other comments, but I think that should give you a sense of the direction we are trying to move: Provide relevant information, but do it in a cost-effective and concise way.

We believe that the SEC has all the power and authority necessary to provide for this kind of disclosure and we would urge that they exercise that authority responsibly. Their active rulemaking agenda and enforcement docket indicates that they are not shy about using the authority that Congress granted to them.

However, we believe that full and clear disclosure, rather than complex over-regulation of payment structures or levels, is the best way to approach fund payments to broker-dealers. We further believe that, with better disclosure, many of these issues can be resolved through the working of the competitive marketplace. So long as fund investors and their financial advisors receive clear information regarding compensation practices, they will be able to choose from the universe of products those that are consistent with their objectives and suitable for their investment goals at a reasonable cost. We hope to work with the Commission to develop disclosure that is meaningful, relevant, and cost effective.

Conclusion

America has changed from a Nation of savers to a Nation of investors. At Raymond James, we believe very strongly that a large number of Americans need access to professional investment advice. A majority of our citizens can now be counted among the investing population, and we know that many of these investors place a significant value on consulting with a financial advisor in planning for their futures. If compensation and payments to broker-dealers are fully disclosed in a manner that is meaningful to the investor, investors can determine whether or not that compensation is fair and acceptable. This decisionmaking process is greatly facilitated by the fact that we operate in a competitive industry that currently presents investors with a range of choice concerning not only products, but also varying models of service that allow investors to choose the level of advice they prefer.

Because we believe that investor protection is paramount to the future of the financial markets and our country's economic well-being, we recommend that disclosure and structural reform efforts should aim to ensure that:

- Fund shareholders are able to readily access meaningful information about the costs they incur, the various types of payments received by the distributors of funds, including broker-dealers and the nature of the services being provided;
- Competitive forces, not Government fiat, set appropriate levels of compensation, whether through fund payments, directed brokerage, revenue sharing, or other structures; and
- Investors are presented with the broadest possible array of fund choices.

Above all, we believe that it is critically important for Congress, regulators, self-regulators, State officials, the mutual fund industry, and the securities industry to work together to restore the trust and confidence of investors in mutual funds as a product, and in those who are committed to providing advice and service to those investors in how to make the best use of that product.

Thank you for your attention.

PREPARED STATEMENT OF THOMAS O. PUTNAM

FOUNDER AND CHAIRMAN

FENIMORE ASSET MANAGEMENT, INC./FAM FUNDS

MARCH 31, 2004

Introduction

My name is Thomas O. Putnam. I am the Founder and Chairman of Fenimore Asset Management, a small investment advisory firm in rural upstate New York. Fenimore has been in business for 30 years and currently has 30 employees and more than $1 billion in total assets under management. At Fenimore, we manage structured portfolios for about 400 individual and institutional clients throughout the United States.

Fenimore also serves as investment adviser to the FAM Funds, a registered mutual fund company offering two investment portfolios with combined assets of approximately $700 million. Each fund has two classes of shares: The investor class, which is no load and is sold directly by Fenimore, and the advisor class—new as of July 2003—which is sold through intermediaries. I serve as co-portfolio manager for each of the mutual funds and also as Fenimore's Director of Research. In addition to my varied duties at the firm, I also serve as Chair of the Small Funds Committee of the Investment Company Institute (ICI).

I am honored to participate in today's hearing on regulatory actions regarding the mutual fund industry and, in particular, fund costs and distribution practices. My testimony will focus on the role of small fund groups in the mutual fund industry and the impact of regulatory reforms on small fund groups. I will also offer the Committee my thoughts on some of the specific reform proposals that have been advanced.

Let me begin, however, by expressing my deep disappointment about the events that have brought us together today. Investors' trust in the entire mutual fund industry has been shaken—and rightly so—by the revelations of wrongdoing that have unfolded over the past several months. That some industry participants would so blatantly disregard their fiduciary duties is both shocking and abhorrent to me. Clearly, there is no place in our industry for this kind of behavior, and I am pleased that the SEC and State regulators have moved quickly to investigate and punish those responsible.

Enforcement actions are just part of what is needed to ensure that the interests of mutual fund investors are fully protected going forward. I applaud the SEC's swift action on regulatory reforms to address the abuses we have seen with respect to late trading and market timing and to place much greater emphasis on fund compliance efforts, which will help to detect and prevent future wrongdoing. I am particularly pleased that certain of the SEC's proposals build in flexibility that may be useful to small funds, rather than taking a one-size-fits-all approach (for example, ensuring that independent directors have the authority, but are not required, to hire staff).

This Committee also has played an important role by thoroughly examining the recent scandals and thoughtfully considering what steps are necessary in response. Finally, mutual fund firms themselves must continue to embrace reforms that will protect investors, who have placed their savings and their trust in the industry.

With all that said, however, I must tell you that I have some serious concerns about the possible scope of this reform effort. Several of the pending legislative proposals, for example, contain provisions that go well beyond the abuses that have been uncovered and, if enacted, could substantially change the face of the industry. Even reforms that are more squarely focused on the abuses could, if drafted too broadly, impose considerable costs on individual fund groups and, ultimately, on fund shareholders. Such reforms also could prove to be cost prohibitive for smaller fund groups, especially those who allow access at a lower minimum (for example, at FAM Funds, the minimum initial investment is $500).

As this Committee considers what steps are necessary to respond to the recent scandals, I respectfully request that you bear in mind the law of unintended consequences. No proponent of mutual fund reform wants to damage the long-term competitiveness and creativity of this industry, the health of which is so vitally important to millions of lower- and middle-income investors. Yet if the scales are tipped too far, so that the regulatory restrictions and costs of managing mutual funds outweigh the possible rewards, there could be a "brain drain" as the best and brightest portfolio managers are drawn away from the mutual fund industry to more creative and lucrative forms of money management. New firms—which historically have developed many of the most innovative fund products and services, such as money market funds—simply might not enter our industry at all, choosing instead to limit their investment offerings to less regulated products. Any departure of top talent could well be followed by an adverse effect on long-term shareholders, including diminished returns and a departure of investors, which would leave fewer investors to shoulder an increased share of their funds' expenses. Finally, the creativity to provide new investment funds that would be advantageous to lower- and middle-income investors might be stifled, if not lost, if a proposal creates a barrier to entry for a mutual fund entrepreneur. That would be tragic.

I hope that these observations about the potential threat of overregulation are taken by the Committee in the spirit in which I offer them—as constructive commentary, based upon my 30 years of experience in this industry and my strong belief that a vibrant, competitive mutual fund industry serves our Nation's interests and the interests of all mutual fund investors, which represent more than half of all U.S. households.

The Role of Small Funds in the Mutual Fund Industry

To appreciate concerns about the impact that some of the reform proposals could have on small funds, I believe that it is important for the Committee to understand this segment of the mutual fund industry.

Many, if not most, investors are familiar with the larger mutual fund groups, such as Fidelity and Vanguard. It is no surprise that people often think of these fund groups first—they enjoy immediate name recognition because of their size and their ability to advertise widely. It would be a mistake, however, to think that these groups are representative of the entire mutual fund industry.

In fact, a large part of our industry is comprised of small fund groups. This point was very well articulated in recent testimony to this Committee by a fellow small fund executive, Mellody Hobson of Ariel Capital Management and the Ariel Mutual Funds.[1] Ms. Hobson noted that more than 370 U.S. mutual fund companies have assets under management of $5 billion or less. This is out of a total of approximately 500 fund companies. To put this fact further into perspective, Ms. Hobson explained that if you were to combine the assets managed by all of these firms into a single firm, the amount under management would be less than half that managed by the single largest mutual fund company.

If you were to ask 10 small advisory firms how they got into the business of managing mutual funds, you would probably get 10 different answers. Here is mine. I was working with my father in the family manufacturing business in the early 1970's. At the same time, my father and I began managing some family money, and we did not suffer losses on our investments despite the bear market of 1973–1974. Word got around, as it usually does in a small town, and we learned that people were interested in what we were doing. We started Fenimore Asset Management and slowly built a client base, largely through referrals by existing clients. Over time, we had many clients who wanted us to manage small sums for them—an account for the benefit of a child or grandchild, for instance. The most cost-effective way to manage small sums is through a pooled investment vehicle, so in 1987, the

[1] *See* Statement of Mellody Hobson, President, Ariel Capital Management, LLC and Ariel Mutual Funds, *Review of Current Investigations and Regulatory Actions Regarding the Mutual Fund Industry: Fund Operations and Governance,* Before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, 108th Cong., 2nd Sess. (February 26, 2004), at 1–2.

firm launched its first mutual fund. Almost a decade later, Fenimore launched its second mutual fund, an equity income fund, in order to meet the needs of clients who wanted an income stream from their investments.

Small fund groups such as FAM Funds play an important role in the mutual fund industry. They provide greater choice for investors and help to foster competition. In addition, a small fund group can typically provide its shareholders a level of individual service and attention that is simply beyond the reach of a large fund group with its millions of shareholders. At FAM Funds, for example, we do not contract any shareholder service activities to outside vendors. Instead, we provide these services through our own team of registered representatives. We also make our portfolio managers available to address shareholder questions and concerns, and we hold shareholder meetings annually at the local high school. In ways such as these, we seek to facilitate dialogue, educate, and create understanding between our shareholders and those of us at FAM Funds to whom they have entrusted their savings.

Many small fund groups specialize in one or more investment styles. At FAM Funds, our specialty is long-term, value-oriented investing. In other words, we are old-fashioned stock pickers. Our investment philosophy is based on the teachings of Benjamin Graham from his classic 1934 book, *Security Analysis,* which outlines the key elements to value investing. Using Graham's methodology, we have developed our own proprietary investment criteria to identify undervalued securities with good long-term growth potential. We consistently apply a thoughtful and disciplined approach to investing that will grow and preserve capital over the long term. In this way, we are able to achieve our overall purpose of providing financial peace of mind to our shareholders.

Unlike a large fund group, which typically offers funds covering a wide spectrum of investment objectives, small fund groups such as FAM Funds find a niche and stick with it. We are not trying to be all things to all investors or to change our investment offerings to capitalize on hot trends in investing, like the technology stock craze of a few years back. Rather, small funds tend to succeed by staying within their circle of competency.

A corollary to this is that a small fund group has to be able to communicate effectively with investors, so that they understand both the benefits *and* the limitations of what the fund group has to offer. A growth-oriented investor, for example, is simply not going to be happy with an investment in my firm's value-oriented mutual funds. Nor would that benefit my firm, since we depend upon the referrals of satisfied clients in order to grow. For this reason, we put a great deal of energy into helping our investors understand our process for selecting stocks and our long-range investment horizon.

The Impact of Regulatory Reforms on Small Funds

In my 30 years as a money manager, I cannot recall another time in which the SEC has proposed so many sweeping changes to the regulatory scheme for mutual funds in such a short period of time. I fully support the SEC's efforts, and I commend the Agency for proposing reforms that are aimed not only at remedying the immediate problems that have been found in the industry, but also addressing potential conflicts of interest, strengthening fund governance, and enhancing standardized fund disclosures. These reforms will benefit investors for years to come. As I stated at the outset of my testimony, however, these reforms—if enacted—would come with a hefty price tag.

It should not be surprising that the aggregate cost of these regulatory changes will have a proportionately larger impact on small fund groups. Small funds have smaller asset bases to absorb these costs, so their shareholders are hit harder than those in large fund groups, where the costs can be more spread out.

In addition, profit margins tend to be much thinner at smaller fund groups, which do not have the economies of scale enjoyed by large fund groups. Consequently, we must be extremely vigilant about controlling costs and keeping our fees at a reasonable level. If we do not, our shareholders can always move their money elsewhere. While this is true for all mutual funds, the costs associated with shareholder defections are more difficult for small funds to absorb. Put another way, small funds must be competitive not only to attract investors in the first instance, but also to retain their business.

An example might be helpful. My firm is working to come into compliance with the SEC's newly adopted rule that requires each mutual fund to have in place a comprehensive compliance program and to designate a chief compliance officer to oversee that program. We are just able to think about bringing on board an in-house counsel at Fenimore who will also serve as the chief compliance officer for each of the FAM Funds. And that is because the costs associated with hiring this new employee would be partially subsidized by our private client business. For fund groups

smaller than ours, or whose investment adviser does not manage other accounts, that approach will simply be too expensive. I expect that such fund groups will have to designate an existing employee to take on the additional—and not insignificant—responsibilities that are required of a chief compliance officer. I offer this example not as a criticism of the new requirement, but merely as an illustration that even worthwhile reforms can stretch the limited resources of small fund groups.

Comment on Select Reform Proposals

Our differences aside, small fund groups and large fund groups agree that the merits of any reform proposal should be measured against a single standard, one that has been the hallmark of our industry throughout its history. That standard is this: Will the proposed reform benefit the interests of long-term mutual fund investors? While well intentioned, some reforms that have been proposed fall short of this mark. Such proposals include, among others, requiring each fund board to have an independent chair and barring a portfolio manager from jointly managing a mutual fund and a hedge fund. In addition, I will offer my observations with respect to certain other areas in which reform proposals have been advanced: Mutual fund fees, Rule 12b–1 under the Investment Company Act of 1940, directed brokerage, soft dollars, and revenue sharing arrangements.

Independent Chair

Several legislative proposals and the SEC's proposed package of fund governance reforms would require that each fund board of directors have an independent chair.[2] While this requirement may sound good in theory, I do not think that a one-size-fits-all approach is necessary. A requirement like this one would cause many fund groups—including my own—to choose a new board chair even though their current structure works well for them.

At FAM Funds, I serve as Chairman of the Board of Trustees, and the remaining trustees are independent. As a practical matter, they already have the power to replace me at any time with a new board chair if they feel that such a change would benefit the Funds and our shareholders. The independent trustees also have appointed a lead independent trustee, who serves as a point of contact with Fenimore and plays a major role in preparing the agendas for our Board meetings. This independent trustee also chairs the separate meetings held by the independent trustees before each board meeting.

I would favor an approach that gives fund boards the ability to choose between having an independent chair and a lead independent director. It is important to note that the appointment of a lead independent director also is consistent with recommended industry best practices.[3] As an alternative to giving fund boards the choice between an independent chair and a lead independent director—or perhaps even in addition to such a choice—the SEC could consider requiring a fund board to elect its chair annually, by a majority vote of both the independent directors and the entire board.[4]

By focusing so much attention on whether fund boards should have an interested or an independent chair, we may well be missing the forest for the trees. What I think persons on both sides of this debate really want are board chairs who are knowledgeable about business, investment, finance, and the fund industry, and who are both capable and willing leaders. Obviously, who fits the bill will depend upon the composition of a particular fund board. For this reason, I feel strongly that board members themselves are in the best position to select their chair.

I also want to share the following observation. Contrary to their portrayal in some recent news stories, fund directors are not lemmings that blindly follow the lead of management. It has been my experience, both at FAM Funds and in the industry, that fund directors take their responsibilities seriously. They recognize their fiduciary obligations and they try to use their best judgment in fulfilling the many duties assigned to them by the Congress and the SEC. If fund directors are charged

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[2] *See, for example, Investment Company Governance,* SEC Release No. IC–26323 (January 15, 2004) (Fund Governance Release). Other reforms proposed by the SEC include requiring that: Independent directors constitute at least 75 percent of a fund's board; fund boards perform annual self-assessments; independent directors meet in separate sessions at least once each quarter; and funds authorize their independent directors to hire staff.

[3] *See Enhancing a Culture of Independence and Effectiveness,* Report of the Advisory Group on Best Practices for Fund Directors (June 24, 1999) (Best Practices Report), at 25.

[4] The SEC requested comment on whether it should require the annual election of the board chair. *See* Fund Governance Release, *supra* note 2. The ICI also supports this approach. *See* Letter from Craig S. Tyle, General Counsel, Investment Company Institute to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated March 10, 2004 (ICI Fund Governance Letter).

with such important responsibilities, they certainly should be treated as responsible enough to choose their own chair.

I support other measures to enhance the role of independent directors, because I know from experience that a strong board is an important partner in protecting the interests of fund shareholders. In particular, I believe that each fund board should be required to have a supermajority of independent directors, as we do at FAM Funds. I do not believe, however, that requiring a three-fourths supermajority for all fund boards—rather than the two-thirds supermajority recommended by industry best practices[5]—would provide any additional benefits to shareholders. On the other hand, such a change would cause significant disruption for many fund boards, most of which already comply with the recommended two-thirds standard. I also support strengthening fund boards by requiring independent directors to meet in executive session at least quarterly, authorizing independent directors to retain their own staff members (although we at FAM Funds believe that our independent trustees already have this authority), and having fund boards annually assess their performance.

Joint Management of Mutual Funds and Hedge Funds

Pending legislative proposals would prevent an individual from managing both a mutual fund and any other type of unregistered investment company, most notably a hedge fund. Although they purport to give the SEC the authority to make exceptions, the authority would be so narrow in scope that the proposals effectively would ban the practice. Fenimore itself does not manage hedge funds, but some of my colleagues on the ICI's Small Funds Committee are very concerned about the possible impact on their firms of such a ban.

My colleagues fear that a ban on joint management would result in reduced access for mutual fund investors to skilled investment professionals who, if forced to choose, likely would opt to manage less regulated and more lucrative types of investment accounts such as hedge funds. In addition, the prohibition could eliminate important operating efficiencies for investment management firms. My colleagues also believe that it could have harsh, disruptive, and anticompetitive effects for smaller investment management firms, which have fewer employees and might not have the resources to maintain separate staff for different types of accounts.[6]

The potential conflicts of interest associated with joint management of mutual funds and hedge funds do not seem to call for such a drastic all-or-nothing approach. Rather, it should be possible to address these potential conflicts and protect the interests of fund investors by requiring advisers who manage both types of products to adopt appropriate policies and procedures. It is important to note that, under the SEC's new compliance rule, such policies and procedures would be subject to continuing oversight by the fund's chief compliance officer and the fund board.

Mutual Fund Fees

Notwithstanding statements by Members of Congress and Federal regulators that they are not interested in rate setting for mutual funds, some proposals have been floated that would seem to move in that direction (for example, requiring specific SEC approval before a fund may charge its shareholders for any new service). Such Government intervention with respect to fees has no place in an industry that is as dynamic and competitive as ours.

I firmly believe that discipline with respect to mutual fund fees and costs comes from two things, and two things alone: Competition in the marketplace, which is fostered in part by the creation and success of smaller fund groups, and transparency, which is fostered by clear and meaningful disclosure to investors about the costs associated with investing in a particular mutual fund.[7] I am pleased that the SEC has taken steps to provide more meaningful fee disclosure to fund investors, in particular by its recent adoption of a rule that will require shareholder reports

[5] *See* Best Practices Report, *supra* note 3, at 10–12.

[6] The negative effects of a joint management ban were well articulated in recent testimony before this Committee. *See* Statement of Michael S. Miller, Managing Director, The Vanguard Group, Inc., *Review of Current Investigations and Regulatory Actions Regarding the Mutual Fund Industry: Fund Operations and Governance,* Before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, 108th Cong., 2nd Sess. (March 2, 2004).

[7] Contrary to the assertions of some industry critics, mutual fund boards are *not* charged with negotiating the lowest possible management fee. But rather, fund directors, acting in an oversight capacity, must ensure that fees are within a reasonable range. They also must evaluate the continuing propriety of fees in light of any material change in circumstances. *See* ICI Fund Governance Letter, *supra* note 4.

to include more detailed information about fund expenses and to present such information in a standardized way, thus facilitating comparisons across funds.

Rule 12b–1

Adopted more than 20 years ago by the SEC, Rule 12b–1 under the Investment Company Act permits payments for distribution from fund assets, subject to several safeguards, which include ongoing board oversight of Rule 12b–1 plans. There is widespread agreement that fund distribution practices have evolved significantly since 1980 and that a thorough review of such practices, and the role of Rule 12b–1, is overdue. I am pleased that the SEC has initiated such a review and has solicited comments from the public on possible reforms to the rule.[8]

One of the pending legislative proposals calls for the outright repeal of Rule 12b–1, and the SEC also specifically requested comment on whether it should repeal the Rule. The Rule should be updated to reflect today's realities but should not be repealed. Rule 12b–1 continues to serve an important function by giving investors choice on how to compensate the intermediaries whose assistance they sought in making their investment decisions. Moreover, many small fund groups have been able to remain competitive because they were able to gain access to a wider array of distribution channels than they otherwise would have through traditional sales load structures.

Directed Brokerage

In keeping with its commitment to acting in the best interests of fund shareholders, the mutual fund industry must be willing to reexamine practices that give even the appearance that a fund's adviser may be putting its own interests before those of the fund's shareholders. One such practice is "directed brokerage," in which an adviser may take sales of fund shares into account when selecting brokers to execute portfolio transactions for the fund. Although the NASD strictly regulates this practice, and prohibits any type of *quid pro quo* between the adviser and broker, directed brokerage involves potential conflicts of interest that could easily be avoided by simply banning the practice altogether.

In December, the industry called on the SEC to put an end to directed brokerage arrangements.[9] Consistent with the industry's recommendation, the SEC has issued a proposal that would prohibit any consideration of broker sales efforts in allocating fund brokerage.[10] I would urge the SEC to modify its proposal, however, so that funds executing portfolio transactions through selling brokers would have the protection of a safe harbor if they put procedures in place to ensure that the direction of brokerage in each instance is based solely on the broker's execution capabilities and is not intended as a reward for its sale of fund shares.

Revenue Sharing Arrangements

Several reform proposals, both in Congress and at the SEC, seek to address the criticism that revenue sharing payments by a fund adviser to a broker selling the fund's shares are not sufficiently transparent to investors. This criticism is a valid one, and I do think reform is needed in this area. An investor buying fund shares through a broker needs to be made aware of any incentives the broker may have to sell those shares. Armed with that information, the investor would be able to evaluate the broker's recommendation in light of those incentives. Knowledge is power, and providing this type of information to investors at the point of sale—as the SEC has proposed[11]—would empower investors to make more informed decisions about how to invest their hard-earned savings.

At the same time, I do not agree that revenue sharing arrangements should be eliminated or that fund boards should be required to make value judgments about whether such arrangements are in the best interests of fund shareholders, as some legislators have proposed. The revenue that is being shared under such arrange-

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[8] *See Prohibition on the Use of Brokerage Commissions to Finance Distribution,* SEC Release No. IC–26356 (February 24, 2004) (Rule 12b–1 Release).

[9] *See* Letter from Matthew P. Fink, President, Investment Company Institute, to the Honorable William H. Donaldson, Chairman, U.S. Securities and Exchange Commission, dated December 16, 2003 (ICI Letter to Donaldson).

[10] *See* Rule 12b–1 Release, *supra* note 8. The NASD also has filed with the SEC a proposal to amend its rules to prohibit broker-dealers from selling the shares of any mutual fund that considers fund sales in making its brokerage allocation decisions. *See Proposed Amendment to Rule Relating to Execution of Investment Company Portfolio Transactions,* File No. SR–NASD–2004–027 (February 10, 2004).

[11] *See Confirmation Requirements and Point-of-Sale Disclosure Requirements for Transactions in Certain Mutual Funds and Other Securities, and Other Confirmation Requirement Amendments, and Amendments to the Registration Form for Mutual Funds,* SEC Release Nos. 33–8358, 34–49148, IC–26341 (January 29, 2004).

ments belongs to the adviser, not the fund, and there are already protections in existing law to ensure that an adviser is not indirectly using fund assets to finance distribution. The fact that revenue sharing arrangements exist simply reflects a basic economic principle that transcends the mutual fund industry—that is, competition for access to available distribution channels.

Soft-Dollar Arrangements

The use of soft dollars by investment advisers is another area worthy of reform. Current law contains a safe harbor that in effect permits a fund's adviser, in certain circumstances, to pay for brokerage and research services using commissions generated by the fund's portfolio trades. The potential conflicts of interest are clear: An adviser may be tempted to (1) select a broker based on such services rather than on the broker's ability to deliver best execution or (2) pay too much in commissions or engage in unnecessary trading to generate soft-dollar credits. In my view, these potential conflicts have been exacerbated by the SEC's broad interpretation of the safe harbor, which allows soft-dollar "credits" to be "redeemed" for products and services that have attributes of traditional overhead expenses and lack intellectual content.

The SEC could easily stem the potential for abuse in this area by narrowing its interpretation of the safe harbor. I support a recommendation made by the ICI in December that would significantly narrow the safe harbor—and thus the use of soft-dollar credits.[12] Requiring advisers generally to pay for research services directly would also promote transparency, making it easier for investors to compare the fees charged by different investment advisers. It is important to note that any reforms relating to the use of soft dollars should apply to all investment advisers, not just those managing mutual funds. Otherwise, not all investors would benefit from the additional protections that would flow from curbing the use of soft dollars.

Conclusion

In closing, I would like to reiterate my support for the SEC's regulatory actions to address the problems that have been uncovered in the mutual fund industry. Going forward, however, I would urge policymakers to be mindful of the potential impact of further changes on small fund groups. As I hope I have demonstrated, small fund groups play a vital role in spurring competition and innovation in the mutual fund industry. In the same way that mutual fund investors benefit from the competitiveness and creativity of our industry, they also bear the costs associated with legislative and regulatory changes affecting the industry. For this reason, it is imperative that any such changes be guided by this single standard: What is best for our Nation's mutual fund investors.

I thank the Committee for the opportunity to present my views, and I offer my continuing assistance as you continue your thoughtful consideration of these important issues.

PREPARED STATEMENT OF MARK TREANOR

GENERAL COUNSEL, WACHOVIA CORPORATION
ON BEHALF OF THE FINANCIAL SERVICES ROUNDTABLE

MARCH 31, 2004

Introduction to Financial Services Roundtable

The Financial Services Roundtable unifies the leadership of large integrated financial services companies. The Roundtable's membership includes 100 of the largest firms from the banking, securities, investment, and insurance sectors. This broad membership, including investment advisers, broker-dealers, and administrators of retirement plans, makes the Roundtable uniquely qualified to comment on mutual fund distribution issues.

Summary of Position on Mutual Fund Distribution

The Roundtable would like to commend Chairman Richard Shelby and the entire Senate Banking Committee for conducting a thorough, deliberate examination of mutual fund issues. The Securities and Exchange Commission (SEC) is also conducting a comprehensive review of mutual fund regulation. Not only is the SEC moving aggressively to consider proposals to prevent recurrences of abusive late trading and market timing, but also the Agency has proposed or adopted rules

[12] *See* ICI Letter to Donaldson, *supra* note 9.

across the entire spectrum of mutual fund operations. The Roundtable believes the regulatory process should be allowed to work before any legislative changes are enacted.

The SEC has put forward for public comment a number of proposals addressing distribution issues.[1] These proposals are discussed in greater detail below. In summary, the Agency is seeking to improve disclosure to investors and possible prohibitions on particular business practices. The comment periods for many of these proposals are still open and the Roundtable expects to file comments with the SEC.[2]

As a result, the Roundtable has not yet taken positions on each specific proposal put forward by the SEC. In general, the Roundtable favors disclosure over prohibitions, including prohibitions on specific types of distribution arrangements. Our goal should be the greatest possible choice for investors. Armed with the appropriate information, investors can choose how they want to compensate the intermediaries who service them. The Roundtable also expresses its views below on improving mutual fund disclosure; strengthening fund ethics and governance; and protecting fund shareholders.

Introduction to Wachovia

Wachovia Corporation is one of the largest providers of financial services to retail, brokerage, and corporate customers throughout the East Coast and the Nation, with assets of $401 billion, market capitalization of $61 billion and stockholders' equity of $32 billion at December 31, 2003. Its four core businesses, the General Bank, Capital Management, Wealth Management, and the Corporate and Investment Bank, serve 12 million households and businesses, primarily in 11 East Coast States and Washington, DC. Wachovia's full-service brokerage, Wachovia Securities, LLC, serves clients in 49 States. Global services are provided through 32 international offices.

Distribution of Mutual Funds

Mutual funds have become the investment vehicle of choice for Americans seeking to reach long-term financial goals. Whether directly or through retirement plans and other investment channels, American investors have turned to mutual funds in order to save and build wealth. Mutual funds offer a convenient and affordable way to make diversified investments in stocks and bonds. Roughly half of all American households own mutual funds; nearly three-quarters of all mutual fund shares are owned by individual investors.

Some investors have the time, sophistication and inclination to investigate and evaluate mutual fund options on their own. Other investors prefer to have an intermediary help them identify their investment goals and funds that may be appropriate to help them meet those goals. In fact, 88 percent of mutual fund shares are purchased through intermediaries. Brokers, financial planners, insurance company separate accounts, retirement plan administrators—all serve as important channels for distribution of mutual funds to the public. They provide investors a convenient means of comparing and accessing a variety of competing mutual fund families.

In addition to distributing mutual funds, intermediaries may have an important role to play in servicing customers' mutual fund accounts on an ongoing basis. Many investors prefer the convenience of receiving a single statement that presents all of their investments, including their investments in various mutual fund families, rather than receiving multiple statements from different financial institutions. Intermediaries may also help investors understand their statements and the performance returns on their mutual fund investments.

It is proper to compensate intermediaries for these services performed at the request and for the benefit of investors. Historically, that compensation took the form of an upfront charge paid by the investor—known as a "front-end sales load." Sales loads typically ranged in amount up to 8.5 percent. Today, compensation may take various forms.[3] "12b–1 fees," so-called after SEC Rule 12b–1,[4] are fees deducted

[1] Proposed Rule: Confirmation Requirements and Point-of-Sale Disclosure Requirements for Transactions in Certain Mutual Funds and Other Securities, and Other Confirmation Requirement Amendments, and Amendments to the Registration Form for Mutual Funds, SEC Rel. No. 33–8358 (January 29, 2004); Proposed Rule: Prohibition on the Use of Brokerage Commissions to Finance Distribution, SEC Rel. No. IC–26356 (February 24, 2004).

[2] The Roundtable would be pleased to provide any comment letters it files for the Committee's hearing record.

[3] "Class A" mutual fund shares may have a front-end sales load, with breakpoints for larger investments. "Class B" shares may have no front-end sales charge, but may have "12b–1 fees" and a sales charge deducted if the shares are redeemed within a certain period of time. "Class C" shares may have no sales charges but have 12b–1 fees.

[4] 17 CFR 270.12b–1.

from fund assets to pay for distribution. Section 12(b) of the Investment Company Act gives the SEC authority to regulate a fund's distribution of its securities, in order to protect fund shareholders from excessive distribution costs.[5] Rule 12b–1 permits funds to adopt written plans for using fund assets to pay for distribution. In effect, 12b–1 fees allow investors to pay for distribution and related costs over time rather than all at once.

Fund advisers make payments to intermediaries for distribution, sometimes known as "revenue sharing" payments. It is important to note these payments are made from the assets of the adviser, as opposed to the assets of the fund. Furthermore, a broker-dealer's registered representatives always remain subject to rules of self-regulatory organizations that require that any funds they recommend to investors be "suitable" for those investors.

Payments by fund advisers or their affiliates may also compensate broker-dealers for performing routine shareholder servicing. These functions may include processing fund transactions; maintaining customer accounts; mailing prospectuses and confirmation statements; and other tasks that mutual funds otherwise perform themselves. Payments for these administrative services have helped foster the development by broker-dealers of mutual fund "supermarkets." These allow investors the convenience of accessing multiple mutual fund families in a single place and receiving a single statement covering their mutual fund investments.

The term "directed brokerage" refers to the use of fund brokerage commissions to facilitate the distribution of fund shares. In general, pursuant to rule of the National Association of Securities Dealers (NASD), a broker may not condition its efforts in distributing a fund's shares on receipt of brokerage commissions from the fund.[6] The rule allows a fund to consider sales of its shares in the selection of brokers to execute portfolio transactions for the fund, subject to best execution and provided the policy is disclosed.[7] In approving this rule, the SEC added that this should not generate additional expense to the fund and fund boards should consider the potential conflict of interest inherent in using fund assets to pay for distribution.[8]

Disclosure of the Costs of Distribution

Mutual fund management fees are paid to investment advisors to select portfolio securities and to manage funds. They do not include all costs and expenses that have an impact on a fund's net performance. Mutual fund investors deserve to know how their assets are being spent on items such as fund distribution. When these costs and expenses are disclosed, investors can make informed decisions as to whether shareholders interests are being served.

Safeguards already apply to the imposition of 12b–1 fees and they are currently disclosed to investors. Under Rule 12b–1, a fund may not use fund assets to pay distribution-related costs except pursuant to a written plan approved by fund directors and shareholders. A majority of fund independent directors must approve the fees each year. Any increase in 12b–1 fees must be approved by both a majority of fund independent directors and the fund shareholders. A fund that charges 12b–1 fees must disclose that fact in its prospectus. A fund is required to disclose how 12b–1 fees increase costs over time and identify them as a separate item in the fund's fee table in the prospectus and as part of the fund's annual operating expenses.

While Rule 12b–1 itself does not limit the level of 12b–1 fees, rules adopted by the National Association of Securities Dealers (NASD) act to do so. NASD rules limit the amount of aggregate mutual fund charges, including sales loads, 12b–1 and service fees.[9] Pursuant to NASD rule, a broker may not sell shares of a mutual fund with a sales load in excess of 8.5 percent of the purchase price, whether assessed at the time of purchase or the time of redemption, and so long as the fund does not charge a 12b–1 fee or a service fee. The sales load of a fund with a 12b–1 fee and a service fee may not exceed 6.25 percent of the amount invested; the 12b–1 fee and service fee of a fund with a sales load may not exceed 0.75 percent per year of the fund's average annual net assets plus a 0.25 percent service fee. A fund also may not advertise itself as a "no load" fund if it imposes 12b–1 fees and/or service fees greater than 0.25 percent.

As described above, as part of its comprehensive review of mutual fund regulation the SEC is seeking comment on potential changes to the distribution of mutual

[5] 15 U.S.C. 80a–12(b).

[6] NASD Conduct Rule 2830(k) (Execution of Investment Company Portfolio Transactions).

[7] *Id.*

[8] SEC Investment Company Act Rel. No. 11662 (March 4, 1981). The SEC has proposed to prohibit mutual funds from directing brokerage transactions to compensate broker-dealers for promoting fund shares. *See* text accompanying footnote 7 below.

[9] NASD Conduct Rule 2830 (Investment Company Securities).

funds, including under Rule 12b–1.[10] The public comment periods with respect to the following proposals remain open and the Roundtable anticipates that it will respond to the SEC's proposals in detail. In general, the Roundtable prefers improved disclosure of distribution and other business arrangements to attempts to prohibit specified types of arrangements.

First, the SEC has proposed amendments to the Rule to prohibit mutual funds from directing brokerage transactions to compensate a broker-dealer for promoting fund shares.[11] A fund that directs any portfolio securities transactions to a broker that sells its shares must have policies and procedures in place that are designed to ensure that its selection of brokers is not influenced by fund distribution issues.[12] Alternatively, the SEC is seeking comment on requiring greater disclosure of directed brokerage.

The SEC has also proposed requiring brokers to provide customers with information about distribution-related costs at the time of purchase of mutual fund shares. Brokers would have to estimate the total annual dollar amount of asset-based sales charges, including 12b–1 fees, that would be associated with the share purchased, assuming their value remains unchanged. Brokers also would be required to disclose the existence of differential compensation—broadly speaking, whether brokers have a greater financial incentive to sell certain mutual funds over others.

Separately, the SEC is also seeking comment on whether to prohibit funds from deducting distribution-related costs, including 12b–1 fees, from fund assets; the proposal would provide instead that they be deducted directly from shareholder accounts with the deduction appearing on account statements.

> Under this approach, a shareholder purchasing $10,000 of fund shares with a 5-percent sales load could pay a $500 sales load at the time of purchase, or could pay an amount equal to some percentage of the value of his or her account each month until the $500 amount is fully paid (plus carrying interest).[13]

Among the potential benefits of this change identified by the SEC are increased transparency to shareholders; reduced payments by long-term fund shareholders; and reduced payments by existing shareholders.[14] The SEC is also seeking comment on whether to rescind the rule.

Other Mutual Fund Issues

The Roundtable would like to share its views on improving mutual fund disclosure; strengthening fund ethics and governance; and protecting fund shareholders.

Improving Mutual Fund Disclosure

A mutual fund's management fee (the fee paid to the investment advisor to select portfolio securities for and manage the fund) does not include all costs and expenses that have an impact on a fund's net performance. The Roundtable believes that mutual fund investors deserve to know how their assets are being spent on items other than distribution, such as brokerage. When costs and expenses are disclosed, investors can make informed decisions as to whether shareholder interests are being served. The Roundtable's member companies agree that aggregate fund brokerage commissions, average commission rate per share, and turnover information are useful types of disclosure. More information could also be disclosed about any services received by a fund in addition to trade execution, such as investment research. But, the Roundtable believes that efforts to require funds or brokers to assign precise dollar values or artificial prices to proprietary services that are not commercially available on an independent basis (such as an in-house research product) are likely to be unworkable and unreliable.

The Roundtable does not support disclosure of actual dollar amounts of compensation paid to individual portfolio managers. Instead, the Roundtable does support disclosure to fund investors of the structure and methodology of portfolio manager compensation.[15] This would help investors understand portfolio managers' incentives and whether the fund will meet their investment objectives.

[10] *See* footnote 1 above.
[11] Proposed Rule 12b–1(h)(1).
[12] Proposed Rule 12b–1(i).
[13] SEC Proposed Rule: Prohibition on the Use of Brokerage Commissions to Finance Distribution, Rel. No. IC–26536 (February 24, 2004), at 9.
[14] *Id.*
[15] *See* Proposed Rule: Disclosure Regarding Portfolio Managers of Registered Management Investment Companies, SEC Rel. No. 33–8396 (March 11, 2004).

Strengthening Fund Ethics and Governance

In addition to robust disclosure obligations, the Roundtable believes mutual funds must have vigorous ethics and governance requirements. At the same time, it is important to understand that mutual funds differ from operating companies. Mutual funds typically do not have employees. Instead, the fund's investment advisor carries out its day-to-day operations.

The Roundtable supports requiring that a supermajority of a fund's board of directors be independent of the fund adviser. Independent fund directors play a critical role in the protection of fund shareholders. Directors approve an advisory contract and oversee the advisor's performance. Oversight by fund boards is the most effective method of managing potential conflicts of interest that could harm fund shareholders. Requiring that a supermajority of directors be independent is an important step toward ensuring that the board carries out this role.

The Roundtable believes that a board with a supermajority of independent directors can determine the individual best suited to serve as chairman and would not support a requirement that the chairman be an independent director. If a nonindependent director serves as fund chairman, certain governance safeguards could be in place to promote the independence of the board as a whole. These include requiring the independent directors to choose a lead director and hire their own counsel; requiring the board nominating committee to be composed entirely of independent directors; and requiring that the independent directors set their own compensation. These measures would ensure that a nonindependent chairman cannot control a board and that independent directors will be able to carry out their responsibilities to fund shareholders.

The SEC has recently taken a step that should enhance the ability of fund directors to safeguard shareholders' interests. The SEC has adopted rules requiring fund directors to approve written compliance policies and programs for both the fund and the fund's advisor. The fund's compliance program will be administered by a chief compliance officer, reporting directly to the board. This will increase accountability and provide fund directors a centralized assessment of fund compliance that is not influenced by the management of the fund's investment adviser.[16]

Protecting Mutual Fund Shareholders

Recent instances of late trading and market timing in mutual funds have undermined investor confidence. Roundtable members care very deeply about restoring investor trust and preventing future abuses. The Roundtable supports a number of additional protections for mutual fund shareholders.

First, the Roundtable supports vigorous additional efforts by the SEC to protect mutual fund shareholders from late trading. From intermediaries to funds, more can and should be done to ensure that all investors are treated fairly in terms of the price they receive when buying and selling fund shares. Roundtable member firms support requiring participants in the process of transmitting investor orders in mutual funds to adopt forceful safeguards against late trading. The Roundtable advocates requiring funds and fund intermediaries, as a condition to be eligible to receive mutual fund orders up to the 4:00 p.m. closing time, to have electronic time stamping systems and abide by associated compliance, certification and independent audit requirements. The Roundtable believes these requirements would better serve investors than the "hard close" at the fund only proposed by the SEC.[17] Roundtable members believe the "hard close" would be disruptive and confusing to investors. Investors buying or selling fund shares through brokerage or retirement accounts could face cut-off times of 2:30 p.m. or even earlier. The Roundtable suggests that it has put forward a more investor-friendly means of preventing late trading.

Roundtable members support vigorous additional efforts by the SEC to guard against market timing. The Roundtable supports the enhanced disclosure by funds of their market timing policies and practices proposed by the SEC.[18] In general, the Roundtable believes it is better to present investors with greater information regarding funds' market timing policies than to enforce new "one size fits all" rules on this issue. The Roundtable also supports the SEC's proposals on the wider use of fair value pricing and on disclosure of that issue and of disclosure to selected parties of fund portfolio holdings.

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[16] Final Rule: Compliance Programs of Investment Companies and Investment Advisers, SEC Rel. No. IA–2204 (December 17, 2003).

[17] Proposed Rule: Amendments to Rules Governing Pricing of Mutual Fund Shares, SEC Rel. No. IC–26288 (December 11, 2003).

[18] Proposed Rule: Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings, SEC Rel. No. 33–8343 (December 11, 2003).

Finally, the Roundtable supports requiring mutual funds to disclose to investors the potential conflicts arising out of the joint management of mutual funds and other accounts.[19] At the same time, fund directors must ensure that advisers do not disadvantage fund shareholders in favor of other advisory clients. Investors can then evaluate the risks in deciding where to invest. A blanket ban on joint management of mutual funds and hedge funds would actually harm mutual fund investors, as many portfolio managers would likely choose hedge funds because they typically offer higher compensation than do mutual funds.

Conclusion

Roundtable members believe disclosure is a crucial tool to ensure that funds serve their shareholders and that shareholders can evaluate fund performance effectively. The Roundtable supports improvements to make certain that fund disclosures are periodic, timely, robust, efficient, uniform, and easy to administer. However, proposals that would increase compliance costs without commensurate increases in investor protection would only reduce returns for mutual fund shareholders. The Roundtable is concerned that mutual funds not be undermined as an attractive product for investors.

The Roundtable is studying the SEC's proposals carefully and expects to file comments with the Agency before the comment periods expire in April and May. As noted, the Roundtable in general feels that improvement to disclosure is a better response to these issues than is prohibition of specific business practices. The Roundtable commends the SEC for its vigorous efforts to ensure that mutual fund shareholders receive the information and protection they need and deserve.

We look forward to continuing our dialogue with the Agency, and the Committee, so investors continue to have confidence in mutual funds as an investment vehicle.

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[19] *See* Proposed Rule: Disclosure Regarding Portfolio Managers of Registered Management Investment Companies, SEC Rel. No. 33–8396 (March 11, 2004).

U.S. SECURITIES AND EXCHANGE COMMISSION

THURSDAY, APRIL 8, 2004

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10:06 a.m., in room SD–538, Dirksen Senate Office Building, Senator Richard C. Shelby (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN RICHARD C. SHELBY

Chairman SHELBY. The hearing will come to order.

This morning, the Committee concludes its series of hearings examining the mutual fund industry. Since November, the Committee has held a total of 10 hearings devoted to the fund industry. This extended hearing process reflects the complex nature of the issues under consideration. During these hearings, we have benefited from expert testimony on the full scope of issues confronting the fund industry. These hearings have educated the Committee and have created a substantial record of reform.

At the beginning of this process, I stated that the guiding principle of reform would be investor protection. I further stated that the regulators, industry, and Congress must work collectively to restore integrity to our markets and reassure investors that mutual funds are a vehicle in which they can safely invest their money. It is against this principle that we must evaluate reform efforts. Although a few months' time is certainly insufficient for final judgment, I do believe that we have a preliminary record to measure the SEC's commitment to reform.

Last November, Chairman Donaldson testified before this Committee that the SEC would reform the mutual fund industry, and he is fulfilling that promise. Under Chairman Donaldson's leadership, the SEC has swiftly executed an aggressive reform agenda comprised of strong enforcement actions, revised compliance and inspection programs, and comprehensive rulemakings. The SEC has promulgated more than 10 rules addressing fund compliance, governance and ethics, conflicts of interest, and disclosure practices. This slate of rules is one of the most comprehensive rulemaking initiatives in the SEC's history. Through these rulemakings, the SEC continues to thoroughly analyze these complex issues and carefully evaluate the benefits and consequences of various reform alternatives. This Committee has spent a great deal of time reviewing the scope, application, and consequences of these rules. Given the revelations of wrongdoing in the fund industry, I

believe that such an expansive rulemaking effort was required. And, Mr. Chairman, I support your aggressive leadership. We commend you for the road you are going down.

As we conclude these hearings, Congress must determine, Mr. Chairman, whether legislation is necessary in light of the SEC's vigorous response. Clearly, Chairman Donaldson and his staff have answered the charge for reform. Nevertheless, I believe it is incumbent upon Congress to determine how we can complement Chairman Donaldson's initiatives and bolster his reform efforts. We, in Congress, have an obligation to the investing public to ensure that the SEC is armed with the full array of powers necessary to fulfill its mission of investor protection. If necessary, I believe that Congress stands ready to enhance the SEC's authority through the grant of new authority. Hopefully, Mr. Chairman, today's hearing will shed more light on what Congress should do to complement SEC's efforts.

And while evaluating the scope of the SEC's authority, this Committee must also measure the SEC's resolve to continue reform. Some issues, such as soft dollars, have not yet been addressed through rulemakings, and the difficult tasks of rule implementation and compliance remain ahead. I believe that true fund industry reform will result from sustained regulatory and enforcement efforts that change the culture inside mutual funds and broker-dealers. This slate of recent rulemakings is just the beginning, Mr. Chairman. Successful implementation and compliance may be the true measure of reform.

I must acknowledge—and I will—the hard work of Chairman Donaldson and his staff during the preceding months. Their timely, thorough, and diligent responses helped to restore investor confidence. Chairman Donaldson, I look forward to your testimony today and perhaps where we might need to go.

Senator Sarbanes.

STATEMENT OF SENATOR PAUL S. SARBANES

Senator SARBANES. Thank you very much, Chairman Shelby. I want to underscore the thorough and comprehensive manner in which you have been examining the problems that have arisen in the mutual fund industry. SEC Chairman Donaldson testified at the Committee's first hearing, as I recall, on this subject, and it is appropriate, that he returns today to testify at the concluding hearing. Chairman Donaldson, I join Chairman Shelby in welcoming you back before the Committee. It is always a pleasure to have you here.

How these mutual fund problems are resolved has important implications for more than half of all U.S. households. About 100 million Americans today own mutual funds. And they count on these investments to provide retirement security, to cover children's education expenses, or to meet other significant financial obligations. Clearly, they must be able to rely on the integrity and honesty of the funds to which they entrust their savings.

As Chairman Shelby has said, we place the interests of the investor paramount. My recollection is there is an engraving at the SEC headquaters from Chairman William O. Douglas that makes

this very point—this is what the SEC is there for, to protect the investor.

The SEC has noted that a 1-percent increase in a fund's annual expense can reduce an investor's account balance in the fund 18 percent after 20 years. This is an arena in which small amounts, which in and of themselves may not look significant, really amount to substantial amounts over a period of time, and we need to be aware of that.

The crisis of investor confidence in our markets was precipitated by the collapse of Enron Corporation and other major public companies, beginning in late 2001. The mutual fund industry continued to assure the public and the Congress that it had no major problems. Those assurances, regrettably, took on a hollow ring in September 2003, first, when the New York Attorney General Eliot Spitzer disclosed that a large hedge fund had engaged in improper late trading and market timing with several major mutual fund families.

Since then, regrettably, numerous instances of misconduct have come to light. As Don Phillips, Managing Director of Morningstar, observed in testimony before this Committee, "Sadly, these were not the acts of a few low-level employees, but instead were violations of trust that took place at the highest levels, including company founders, CEO's, and portfolio managers."

The Director of Enforcement at the SEC, Stephen Cutler, said in November, "More than 25 percent of firms responding to an SEC mutual fund inquiry reported that customers have received 4 p.m. prices for orders placed or confirmed after 4 p.m., 50 percent of responding fund groups appear to have had at least one arrangement allowing for market timing by an investor. And almost 70 percent of responding brokerage firms reported being aware of timing activities by their customers."

In the wake of public disclosure of these improprieties, the SEC, under the effective chairmanship of Chairman Donaldson, the NASD, the State Attorneys General, and the State regulators have responded forcefully. The regulators have brought enforcement actions, enhanced their examination functions, and are engaging in extensive rulemaking.

Chairman Donaldson has said, "The Commission is deeply committed, to try to restore investor confidence in fund investments." And his actions and those of his fellow Commissioners have demonstrated their determination in seeking that goal. *Business Week* recognized recently, and, "The SEC chief has accomplished more than many expected."

From the testimony at our hearings, the Committee has learned much about the regulators' and the industry's response to the concerns about such issues as: Late trading, market timing, selective portfolio disclosure, fee disclosures, fund governance, soft dollars, side-by-side management of mutual funds and hedge funds, and disclosure of adviser compensation. This has helped us to gauge the extent of the problems, their impact on investors, and what is being done to prevent future abuses.

The SEC has brought several enforcement actions and engaged in a dozen rulemakings affecting mutual funds, which include many appropriately strong proposals. The SEC actually is review-

ing public comments on many of these, so a number have not yet been finalized. And we are awaiting the final rules, and, of course, the Commission carries a heavy responsibility in that regard.

Our witnesses have brought to our attention matters involving transparency, accountability, and conflicts of interest. We have had a number of proposals made to the Committee on how we might proceed in those areas. There are other areas where the SEC has not yet had the opportunity to formally address the issue or is studying or soliciting comment on the matter.

I look forward to hearing the Chairman Donaldson's assessment of the current situation, whether the full dimensions of the problems in the fund industry have surfaced, how the SEC is addressing the problems, and what is planned for the future, and how the Congress can work with the Commission to promote the integrity of the fund industry and to protect the fund investors.

It is obviously of very great importance that we all work together in order to assure a framework with respect to industry practices that enables the investor to be confident that he or she will be dealt with in a fair, straight-forward, and honest manner.

Thank you very much, Mr. Chairman.

Chairman SHELBY. Senator Bunning, you may have arrived just in time. We will move back and forth.

STATEMENT OF SENATOR JIM BUNNING

Senator BUNNING. Thank you, Mr. Chairman.

First of all, I want to thank you for holding the hearing, and I want to thank our witness, Chairman Donaldson, for testifying.

As my colleagues know, I was in the securities business for 25 years. I actually sold mutual funds, so I am very familiar with the subject.

There has been a lot of talk about the mutual fund bill. A lot of talk. The House has passed a bill. Some of my colleagues on this Committee have introduced a bill. And Senators not on this Committee have introduced a bill. Chairman Shelby recently indicated that he would lean toward passing a bill this year. I am not in the habit of disagreeing with my Chairman, but it will be a high hill to climb to convince this Senator that we must pass a bill this year.

Chairman Donaldson came in at a very difficult time. I have disagreed with a lot of his actions, but he has been active. He has moved to curb abuses and has moved to establish the SEC as the regulator for securities once again. I believe the SEC has reestablished its authority. If you do not believe me, I ask the securities industry people who are filling the audience today. We have greatly increased the SEC resources over the past few years. This Committee has taken the lead on making sure the SEC does have the resources it needs. I believe—and I think Chairman Donaldson agrees with me—that the SEC currently has the resources to enforce the authority and enforce the law. I think they can effectively regulate the mutual fund industry under existing statutes. I am sure the securities industry will agree with me on that, also. We have given the SEC a lot of resources. I believe it is time to let them use them. If they go too far or not far enough, then I am sure this Committee will be getting involved.

One area where I think the Commission has already gone too far is the independent chairman issue. I completely disagree with the Chairman on this issue. If we have independent boards and the SEC required boards to be 75 percent independent, we should let them pick whoever they want as chairman. Let it be their choice. If they believe it is in the best interest of the investor to have a management chair, they should be able to have a management chair. There have been studies showing that funds with independent chairs have a much worse return.

I also favor the idea of having someone who will be accountable. Funds with a management chair do have someone who will be accountable if there is a problem with the fund rather than saying, "I was independent. How could I know of any of these problems?" Let the independent boards pick who they believe is the best chair for a particular fund.

Thank you, Mr. Chairman, for holding these hearings, and I am anxious to hear from Chairman Donaldson.

Chairman SHELBY. Before I call on Senator Reed, I just want to set the record straight as of today. I do not deny that I said I was leaning toward legislation. That was days ago or weeks ago. Today I am leaning straight up. I am not leaning toward legislation.

[Laughter.]

Because I think that as we reviewed the testimony that has come before the previous nine hearings and we have put together what the SEC has been doing, I think at the end of this hearing we will see from Chairman Donaldson's testimony and what they are going to do, and maybe, Senator Bunning, we should let the SEC do its work, continue our oversight, not rule out any legislation in the future but not be rushing to judgment on legislation.

Senator BUNNING. I think that is a great idea, Mr. Chairman.

Chairman SHELBY. Thank you.

Senator Reed.

COMMENTS OF SENATOR JACK REED

Senator REED. Thank you, Mr. Chairman. Thank you also for holding these many hearings on this very important topic. Welcome, Chairman Donaldson.

The Securities and Exchange Commission has put forward a comprehensive package of proposals that would fundamentally change how this industry operates, and I look forward to hearing from you, Mr. Chairman, about these proposals and encourage you to let us know what we can do to assist you, particularly if you believe you need additional Congressional authority.

We must continue to keep in mind that mutual funds represent one the best ways for individual investors to participate in the market. Millions of Americans rely on these funds to have easy access to diversification and the management skills of an experienced investor adviser. With so many Americans investing and benefiting from mutual funds, Congress has an important responsibility to ensure that all investors are treated fairly and equally.

Thank you, Mr. Chairman. I look forward to your comments.

Chairman SHELBY. Senator Corzine.

STATEMENT OF SENATOR JON S. CORZINE

Senator CORZINE. Thank you, Mr. Chairman. And let me congratulate you on running a terrific set of hearings with respect to this overall topic.

Chairman SHELBY. Thank you.

Senator CORZINE. Those nine hearings that you talked about are really quite a tutorial on the industry, the issues, and the problems. And I must say I have learned a lot, and as you know, along with Senator Dodd, we introduced an original piece of legislation, S. 1971, which we intend on using the extensive testimony as a basis to upgrade and update many elements of it.

That said, I want to identify with what both Senator Bunning and Senator Reed said with regard to the SEC, which does mean maybe leaning into the wind or standing straight up, may be is an appropriate point. I think it is one of those issues we should have some discussion about today. But I think the SEC has done a great job as it relates to the mutual fund industry and taking a comprehensive response. Everybody can disagree on elements of all kinds of policies, but I think it has been quite effective in a very troubled time. And I think the reestablishment of the credibility of the SEC has been really quite extensive, and I think that comes in part from the leadership. And I welcome Chairman Donaldson here and I congratulate him for those efforts.

But there still is a lot to debate about whether making permanent some of the very thoughtful ideas and elements of the proposals that the SEC has come across, particularly in the context of we are where we are today, but if we have difficulties down the road, do we end up then not thinking through this in as thoughtful and as precise a way and then end up having what I think are less effective long-run formulations for it. And so there is a case to be made for having some of this put into statutory format. So I would like to hear the arguments back and forth on why, but I think we have all experienced situations where we react to a crisis in a much different format than what we do when we have the ability to actually think objectively in periods that may be a little bit off the front burner. And that is certainly what I would like to see us at least examine.

I thank you, Mr. Chairman, for a very, very effective dialogue with regard to this whole effort.

Chairman SHELBY. Thank you.

Senator Stabenow.

STATEMENT OF SENATOR DEBBIE STABENOW

Senator STABENOW. Thank you, Mr. Chairman. I also would like to thank you for a very thorough set of hearings, and it has been very enlightening for all of us. There is no doubt that there has been some troubling findings over the last year which have indicated that some funds are not looking out for the best interests of their investors. And, in addition, it is clear we need more transparency in the industry as we have talked about.

But I am very encouraged by the leadership that we have seen both by regulators at the State and the Federal level, and I am particularly glad that Chairman Donaldson is before us today to update us on the actions that the Commission has, in fact, taken.

There is so much that can be done through the regulatory policy process, and I am confident that the actions of the SEC and other regulators are beginning to have a corrective impact on the problems that we have been uncovering.

I know that, Mr. Chairman, you have indicated that you want to look at the issue comprehensively and then determine if there is more that needs to be done legislatively. I appreciate that. I appreciate your careful and methodical approach to this. We want to make sure that we solve the problems at hand, but do so in a way that is measured and appropriate. The need to resolve investor confidence in the market for mutual funds and in the markets at large remains a paramount concern of mine, as I know it does of yours.

In addition to looking at the mutual fund industry, though, I might add that we also need to remain vigilant in looking at the implementation of the Sarbanes-Oxley Act, and with the Chairman here, I do want to take the opportunity again to say that I am particularly concerned about provisions in the Act that relate to the anonymous corporate whistle-blower provisions. We have talked, you and I, about this, and I am concerned that we have not yet seen the aggressive implementation or monitoring by both the stock exchanges and by the SEC as it relates to those provisions. And I continue to urge you to do so.

And as we look at our provisions there, the whistle-blowers, who serve as our first line of defense in combating corporate fraud and misleading accounting, need to know that there is a confidential process and that it is a specific process. And I will continue to look forward to working with you on that very important piece of the legislation.

And, again, thank you, Mr. Chairman, for this hearing.

Chairman SHELBY. Senator Carper.

STATEMENT OF SENATOR THOMAS R. CARPER

Senator CARPER. I will be very brief.

Chairman Donaldson, thank you for joining us today, and thank you for the good work that you and the SEC are doing. I have learned in the 3 years I have been in the Senate that sometimes you have to pass legislation to accomplish certain objectives. Sometimes you can do so by circulating a letter and getting a lot of your colleagues to sign on and send that letter to a key decisionmaker.

Sometimes you can accomplish a whole lot by having a hearing, other times by having an extended series of hearings. And I think what has happened over this series of hearings is you and those who work with you at the SEC have had an opportunity to make some decisions, study the field, and to step forward and say these are the changes that we would like to see made. And I think for the most part, what you are doing are things that I agree with—not all, but for the most part, I agree with you and appreciate the diligence and the determination that you have brought to the task. If you need to do more, maybe we can have more hearings, give you more time to finish those things.

I look forward to asking you some questions. I will just telegraph one of them, and that is the question of the need for an independent chairman, the same issue raised by Senator Bunning. If

that is something that is truly going to be of value or not. So having telegraphed that pitch, I look forward to hearing from you.

Thank you.

Chairman SHELBY. Chairman Donaldson, before you start, I just want to say what others are saying. We believe that your leadership at the SEC has been exemplary. You have been facing the tough issues, and you will continue to do this. We want to work with you. We are going to continue to work with you, as we have in the past, as the Banking Committee, with legislative and oversight jurisdiction of the SEC.

In your remarks today, I hope you will tell us where we need to work with you specifically, on oversight or in legislation, or defer legislation, or what, because I believe we need to see how your regulations are going to work before we rush to judgment legislatively.

You proceed as you wish. Your written testimony will be made part of the record in its entirety.

STATEMENT OF WILLIAM H. DONALDSON
CHAIRMAN, U.S. SECURITIES AND EXCHANGE COMMISSION

Mr. DONALDSON. Good morning, everyone. Chairman Shelby, Ranking Member Sarbanes, and other Members of the Committee, I am delighted to be here. I thank you for inviting me to testify today.

Senator BUNNING. Could you move the mike a little closer?

Mr. DONALDSON. Yes.

Senator BUNNING. Thank you.

Mr. DONALDSON. The breadth of your hearings have clearly and effectively illustrated the complexity of the issues the Commission is facing in addressing the problems in the mutual fund industry. The hours upon hours that you and the Committee have spent performing critical oversight, and the testimony from witnesses representing all sectors and aspects of the problem have been immensely valuable as the Commission works to tackle these issues. I thank and commend you for the thorough and thoughtful approach that this Committee has brought to the problems.

Like you, as I said many months ago, I am outraged by the conduct that has come to light in the recent mutual fund scandals. In large part, I believe that the industry lost sight of certain principles, in particular, its responsibility to the millions of investors who entrusted their life's savings to this industry for safekeeping. As I said last fall when I testified—and I believe it bears repeating—these mutual fund investors are entitled to honest and industrious fiduciaries who sensibly put their money to work for them in our capital markets. Investors deserve a brokerage and a mutual fund industry built on fundamentally fair and ethical legal principles. This has been the Commission's urgent and guiding mission as it pursues a very aggressive mutual fund reform program to identify and address a range of problems in the industry.

Our regulatory efforts include strengthening the governance structure of mutual funds, addressing conflicts of interest, enhancing disclosure to mutual fund shareholders, and fostering an atmosphere of high ethical standards and compliance within the industry.

The Commission has made significant progress and will continue to move aggressively to track down and pursue wrongdoers while expeditiously considering all of the outstanding mutual fund rulemaking proposals: market timing disclosure, breakpoint disclosure, the fund governance package, the investment adviser's code of ethics rule, disclosure regarding the factors considered by the fund's board in approving an advisory contract, the proposed amendments to Rule 12b–1, the hard 4 p.m. close, portfolio manager disclosure, the mandatory 2-percent redemption fee, and new confirmation form and point-of-sale disclosure, to mention a few.

While it is important that we act on these rules in an expeditious manner, it is, in my view, equally important that we get it right. Interested parties must have the opportunity to comment, our staff must have sufficient time to fully consider possible unintended consequences, and we need appropriate time to vet alternative approaches to our proposals so that when we adopt final rules we will adopt rules that best address the problems we are seeking to solve.

The complexity associated with some of our proposals, such as our proposal on late trading, may take some additional time to ensure our solution appropriately addresses the underlying problem.

As you have no doubt seen in your hearings, there are divergent views among knowledgeable experts over how best to address mutual fund oversight. Because these views often conflict with one another, particularly among competitors, the Commission's notice and comment process, which Congress so wisely required in all Commission rulemakings, is of infinite value to our final product. We benefit from a wide spectrum of views and opinions put forth in a formal, structured format on how to strengthen our proposed rules and regulations, the practicalities of implementing these rules and regulations, and, most importantly, alternative approaches to address the underlying goals.

My written testimony provides significant detail about the agenda the Commission has undertaken. Today, I would like to just briefly describe some of these key reforms and then answer any specific questions that you have.y

First of all, on the 4 p.m. rule proposal, to put an absolute halt on abusive late trading practices, the Commission proposed the so-called hard 4 p.m. rule. This rule amendment would provide for a secure pricing system that would be largely immune to manipulation by late traders by requiring that orders be placed with the fund or its primary transfer agent or clearing firm by the time set by the funds.

To date, the Commission has received more than 1,000 comment letters on this proposal, many raising concerns about how the proposal might adversely impact certain fund investors, such as 401(k) plan participants and investors in earlier time zones. As an alternative to the proposal, some have advocated a system of controls that would better prevent and detect late trading. Others have recommended the use of more sophisticated technology to create tamper-proof timestamping of trade tickets that would help eliminate, or at least better detect, late trading. The staff is analyzing this information to determine whether there is an effective alternative to the hard 4 p.m. proposal that would not disadvantage certain investors and does not distort competition in the marketplace. It may

very well turn out that we adopt a combination of some of the alternatives that have been presented to us during the notice and comment process. Again, the hard 4 p.m. rule proposal illustrates the effectiveness of the Commission's rulemaking process, whereby we, and indeed the investing public, are the beneficiaries of a wide range of views and perspectives and possible solutions.

It is a complicated situation, and, of all the things we are working on, it may be the one that is going to take the most time for us to come up with a compromise solution.

As far as disclosures to fund investors, improved disclosure—particularly disclosure about fund fees, conflicts, and sales incentives—has been a stated priority for the Commission's mutual fund program in the months before the trading abuses came to light. The Commission adopted a requirement that shareholder reports include dollar-based expense information so that investors can easily compute the dollar amount of expenses paid on their investment in a fund. Some have questioned whether we should have required more information, that is, individual account information to each shareholder. While the staff and the Commission considered this alternative, we were convinced that the dollar-based expense information that the Commission ultimately adopted was a better course, as it allowed for comparability. We have ongoing efforts to examine the entire mutual fund disclosure regime to see if it is as good as it can be. However, I firmly believe we need to give this particular rule—which will go into effect in July—a good chance to operate before we begin to contemplate changing it.

Internal reforms within the Commission. Last year, following a thorough internal review of how the Agency deals with risk, we initiated a new risk management program and laid the groundwork for an Office of Risk Assessment and Strategic Planning, the first of its kind at the Commission. The first phase has been to organize internal risk teams for each major program area. This framework has already been put into place and allows for what I like to think of as a bottom up approach to assessing risk in each of our divisions. A good example of this is through our Office of Compliance, Inspections, and Examinations, OCIE. We have empowered our examiners, through OCIE's internal risk management team, to look at potential problems in the mutual fund industry and broker-dealer industry and to formally examine these for potential problem areas.

The new Office of Risk Assessment will work in coordination with these internal risk teams throughout the entire agency and push the Agency to proactively identify potential problem areas within the mutual fund and broker-dealer industries, focusing on early identification of new or resurgent forms of fraudulent, illegal, or questionable activities. In addition to fostering better communication and coordination between the divisions and offices within the Commission, the risk assessment initiative will help to ensure a process whereby senior managers at the Commission have the information necessary to make better, more informed decisions, and to proactively adjust operations and resources and methods of oversight to address these new challenges.

We have also greatly enhanced our examination program. Budget increases in 2003 allowed us to increase our staff for fund examina-

tions by a third, to approximately 500 people. These new resources, coupled with the Office's new risk-based examinations approach, should greatly improve our ability to detect abusive behavior and possible violations of law.

Another critical aspect of our risk assessment effort has been the creation of special multidivisional task forces that were designed to bring together staff from various divisions and offices to brainstorm, evaluate, and create strategies to proactively undertake issues of potential concern in protecting our securities markets.

Four of these task forces, which are under way now, will tackle issues that will help us better protect mutual fund investors. They are called the Chairman's Task Forces on Soft-Dollar Arrangements, College Savings Plans—or the so-called 529 plans—Enhanced Mutual Fund Surveillance, and Disclosure Regime. The task forces will meet with the relevant interested parties, such as individual investors, industry representatives, and fellow regulators, to gather critical intelligence and data and ultimately work toward addressing problems over the long haul. All of these task forces are discussed in detail in my written testimony.

Because I know that the issue of soft dollars is of particular concern to the Committee, just as it is to the Commission, I want to draw attention to the Task Force on Soft Dollars and our efforts to address this issue.

The Task Force on Soft Dollars, comprised of SEC staff from five divisions and offices, has already met with a number of industry representatives as it tackles this very complicated issue. Its goal is to fully understand all aspects of how soft dollars are used and the pros and cons of various alternative reform approaches, including the possible unintended consequences. While the task force is working expeditiously to provide recommendations, I want to ensure that the staff has adequate time to fully consider the issue and meet with interested persons so that it can come in with what we hope are the best and most informed recommendations possible.

Like so many of the issues that we are facing, the area of soft dollars is very complex, and we have to be cautious, in my view, as we move forward with reforms. At the very least, the Commission, through the rulemaking process, should consider narrowing the definition of qualifying "research" under the safe harbor so that only "real" research that has valid, intellectual content, qualifies. I also expect the Task Force to consider whether the costs of research and execution should be quantified and separated and other ways that make the costs of research and the costs of execution more transparent. Some have advocated a distinction between third-party research and proprietary research. My view is that we should not draw such distinctions, but the Task Force will also consider this issue and provide recommendations.

I would like to say a few words about hedge funds. The issues surrounding hedge funds are an excellent example of how the Commission can be proactive and work to enhance enforcement in problem areas before they spread. Indeed, this is why I believe our risk assessment and internal reforms are so important. While my written testimony describes my concerns in detail, I would like to summarize just a few points now with the caveat that these are my

own views and do not necessarily reflect the views of the entire Commission.

One of the views I often hear in the context of this issue is that hedge fund investors are wealthy and sophisticated individuals who do not need protecting. This, in my view, is not the point. Hedge fund managers are, directly and indirectly, providing advisory services for many U.S. investors, with significant impact not only on those investors but also on the operation of the U.S. securities markets. The Commission is the only Government agency that is charged with protecting those investors and policing those markets. Hedge funds are being purchased by intermediaries on behalf of millions of ultimate small investor beneficiaries—retirees, pensioners, and others not generally thought of as the traditional hedge fund investor. The increased employment of hedge funds by pension plans or funds of hedge funds makes it critical for investors that the Commission have basic information and a resulting insight as to how many hedge fund managers are deploying assets under management, how they handle their conflicts of interest, how they account for results and value their investments, and, most importantly, in my view, what impact their market activities have on the other participants in our equity markets.

The SEC is responsible for enforcing the Federal securities laws, policing the securities markets, and ensuring fraud prevention and detection. This is the Commission's responsibility, regardless of whether we are talking about mutual funds, self-regulatory organizations, public companies, hedge funds, or other market participants. Hedge funds have become one of the fastest growing segments of the investment management business, with assets fast approaching $1 trillion, at a time when returns on other investments have not kept pace.

Other Government entities, particularly the Federal Reserve Board and the Treasury, are responsible for monitoring potential systemic risks and the safety and soundness issues raised by the structure of these vehicles. While their oversight priorities are of great importance to our banking system, these agencies are not responsible for enforcing the Federal securities laws and protecting investors. The data they collect is aimed at the discharge of their prudential oversight responsibility.

It troubles me that the Commission, under the current rules, is limited in its ability to gather information that could help protect millions of investors. What we have found in the mutual fund scandal supports this concern. We have seen hedge fund managers engaged in illegal behavior that results in taking advantage of the long-term retail investors and these funds. Critics, in my view, cannot have it both ways—on the one hand, to demand that the Commission be proactive and prevent and detect emerging but as of yet unforeseen, harms and abuses, but, on the other hand, to handicap our ability to obtain simple, fundamental information that facilitates our identification of such abuses.

Building on the risk assessment capability we are developing in the Agency, we could consider a form of registration and an oversight regime for hedge fund managers different from that which we use for other, more heavily regulated entities, like mutual funds. They could be specifically tailored to the unique dynamics of these

funds and managers. We could thus better target our inquiries on those hedge fund managers where there is some reasonable concern that they may be violating Federal securities laws.

I intend to ensure that the Commission's consideration of the hedge fund issue, which in many ways is an extension of pooled vehicles, be thoughtful and thorough, and that any proposal that we put forth will be fully and appropriately vetted.

Let me just touch for a moment on the enforcement efforts. Let me note now our four key enforcement areas related to mutual funds: one, late trading and abusive market timing; two, mutual fund sales practices, including fee disclosure issues in connection with the sale of mutual funds; three, the sale of different classes of mutual funds; and finally addressing the failure of firms to give their customers the discounts available on front-end loads for large purchases of Class A shares.

For the enforcement program's current area of focus in the mutual fund arena, the staff is continually on the lookout for additional mutual fund practices that may be vulnerable or ripe for abuse. Accordingly, the staff is closely examining, among other things, the status of funds closed to new investors that, nevertheless, continue to charge Rule 12b–1 fees, the portfolio pricing practices of high-yield bond funds, the role of pension consultants and pension plan selection of particular mutual funds as their preferred investment vehicle, and the reasonableness of management fees charged by certain index funds. In all of the foregoing areas, the Commission is intently focusing on the roles and conduct of mutual fund directors. Have they adequately discharged their responsibility? Have they properly overseen the mutual fund management company on behalf of mutual fund shareholders?

As my testimony illustrates, the Commission has embarked on an aggressive regulatory and enforcement agenda. I believe our efforts will help to ensure that there are strong safeguards in place to minimize the possibility of future illegal, fraudulent, or harmful activity. We have had ample regulatory authority with which to carry out this agenda and, due in large part to your support and your constructive approach, we have been able to pursue this agenda in an expedited manner.

Let me once again compliment the Committee, Mr. Chairman, for its thoughtful and thorough approach to the oversight of this issue. The significant number of hours that you and the staff have spent conducting these oversight hearings and questioning witnesses from all segments of the industry have been immensely helpful to the Commission and represent a constructive approach to analyzing the complexity of the problems that have plagued the mutual fund industry for quite some time. The Commission and indeed the mutual fund investor have benefited from your approach.

If, as the Commission moves ahead with its mutual fund reforms, there are critical issues that we do not have the ability to address, the Commission will immediately seek your assistance to do so; however, I do not believe that at this time legislation is necessary, and, in fact, that legislation could impede the speed with which we move forward on some of the rules that we have put forward.

Thank you again for inviting me, and I would be delighted to answer any questions.

Chairman SHELBY. Chairman Donaldson, just to follow up on what you just said, do you believe that the Securities and Exchange Commission has the authority and the power it needs to adopt the full complement of rules necessary to reform the mutual fund industry? At this point in time, do you believe that?

Mr. DONALDSON. Let me just say that I think the Commission has the tools it needs to address the critical areas. Our rulemaking authority under both the Investment Company Act and the Investment Advisers Act gives us ample authority to act in virtually every area, not only to address the late trading and market timing abuses, but also strengthen fund governance, enhance ethical conduct, increase compliance, et cetera. The notice and comment process provides the great benefit of allowing us to receive these great thoughts.

We have some 10 proposed rules on the docket. We have approved an additional two rules. We have a concept release out. Our comment period has closed and is closing through all the way to the end of May. I believe that by summertime we will be in a position to make final rule determinations, with the exception of one or two, the hard 4 p.m. close being the most appropriate one.

But to answer your question, I believe we do have the authority that we need at this juncture, and I also assure you that if we find, as we move ahead, particularly on a longer-term basis with some of the task forces, that we do not have the proper authority, we will come back to you and ask for it.

Senator SARBANES. Mr. Chairman, I think if you would pull that microphone closer to you, it would be——

Mr. DONALDSON. I am sorry.

Chairman SHELBY. Thank you, Senator Sarbanes.

Many of the legislative proposals that have been floating around in the House and the Senate would essentially either codify or ratify areas contemplated by the SEC in your rulemaking. Is there a need at all to codify or reaffirm the SEC's rulemakings in any respect? Or should we give you that time to see how these rules are, first, proposed, adopted, and implemented?

Mr. DONALDSON. As I said, we are moving aggressively to adopt the rulemakings. I believe we have the necessary authority. I believe that there is no need at this juncture to codify by new laws what we are doing. As I intimated, I think, to stop in this process now and to start a whole new process would be counterproductive to what we are doing.

It is not just me. It was the microphone.

[Laughter.]

And as I say, I think that, if we need further help, we will come back to you.

Chairman SHELBY. This is digressing a little, but you brought up the subject of hedge funds. Right here, in this Committee, the Chairman of the Federal Reserve, Alan Greenspan, I asked the question about regulating private hedge funds, and he said he was not for that. Have you ever discussed this proposal with him? Or do you all just have a difference of philosophy here?

Mr. DONALDSON. Again, let me, if I might, digress on that a bit, because I have spoken with Chairman Greenspan on a number of

occasions. I also have had our staff meet with the Federal Reserve people to discuss the whole issue.

I referred briefly to this in my testimony. I read Chairman Greenspan's testimony, and I think he started out by saying, "I am against it," and then he said, "I am not really against the rule. I am worried about what you are going to do with it."

Chairman SHELBY. That is right.

Mr. DONALDSON. I think that was his statement, and I think we have to draw a distinction between the Federal Reserve and the Treasury Department's responsibility here in terms of the prudential oversight of the financial system and the banking system and the information that they gather for that. That is their role.

We have a different role. Our role is investor protection and the policing of securities laws, and we have a very different mission. And I believe that the Federal Reserve and Chairman Greenspan—looking back to the Long-Term Capital days—believes, and I think rightly so, that the liquidity provided by hedge funds is an important risk-offsetting capability they have, and worried at that time that any attempt to legislate that hedge fund could be counterproductive. But we are talking about something totally different.

Chairman SHELBY. We are talking about oranges instead of apples.

Mr. DONALDSON. Exactly. And I believe that—not to beat a dead horse here, but I believe that we must have the simple capability to look inside hedge funds and find out what is going on, not to protect the wealthy investors, although do that, too, but to make sure that the market impact on other investors—I call it "the other side of the trade"—be examined.

Chairman SHELBY. Thank you.

Senator Sarbanes.

Senator SARBANES. Thank you very much, Chairman Shelby.

Chairman Donaldson, we always pay attention to what Chairman Greenspan recommends because he has been around a long time and has provided some important leadership to the country.

On the other hand, just 3 years ago, he appeared before us and told us that we were paying down the national debt too quickly and that we needed to change the trajectory of paying off the national debt and, therefore, we could enact a large tax cut without worrying about deficits and without impeding continuing to pay down the national debt. We would just slow it up a bit because it was being paid off too quickly. That was 3 years ago, and, of course, we know where we are now, you know you are working within your own area of expertise, and I simply commend you to carry forward in that regard.

Now, having made that diversionary statement, let me——

Mr. DONALDSON. If I might just interrupt and say I have the highest regard for Chairman Greenspan.

Senator SARBANES. Oh, yes. We ought not——

Mr. DONALDSON. I guess it is just a matter of who is responsible for doing what.

Senator SARBANES. Well, yes, but we ought not to get to the point where, if people have very good reasons for disagreeing with a position of his, they ought not to take it or should feel uncomfortable about putting it forward. And I just mention this 3-year-ago rec-

ommendation and his view that the debt was being paid off too quickly.

Now, let me ask a diversionary question as well. A week ago yesterday, you appeared before the House Appropriations Subcommittee to discuss your budget. In that testimony, you indicated that you had yet to fill hundreds of new staff positions made available to you by the substantial budget boost that the Commission has received and which Members here have, I think almost without exception—I think without exception, have been supportive of. In fact, you currently have, according to this article in the *National Journal,* 525 vacant staff slots, although you expect to fill 100 of them by the end of May.

Subcommittee Chairman Frank Wolfe, our colleague on the House side from Virginia, said he was shocked the SEC has not yet found enough high-quality, capable people to fill these jobs. "I am surprised that you are having trouble," Wolfe said. "What you are doing is really exciting, it is important, it is public service, and that is a good salary." And, of course, the starting salaries now are running at about, I guess, $75,000, which, of course, for a Government starting position is pretty good money. And a senior-level SEC accountant with 20 to 25 years' experience could earn an annual salary of more than $186,000. I am just putting this out there so people know there are some career possibilities down at the SEC.

[Laughter.]

But how are you coming? This is important. Last year, you turned back about $100 million, as I recall, to the Government and I think that generally met with approval because, you know, there is no sense in you going out and spending the money if you cannot spend it wisely.

But we are now into another budget year. We want to get the Commission staffed up. I know you have done pay parity on the salaries. I do not think you have done it yet on the benefits, as I understand it. I do not think that has been brought to a conclusion.

So how are we doing on this whole issue of staffing the Commission and getting you up to full strength?

Mr. DONALDSON. If I do not bore you, let me try and bore in a little bit on these figures because they are confusing.

We received 842 new position authorizations back at the end of 2002, the beginning of 2003. But those are not all the positions that we have to fill. In total, we have worked to fill 1,265 position because we have people leaving the Agency, and that has been one of the problems of the Agency over the last few years.

Senator SARBANES. Well, I gather you have cut that down considerably, and I commend you for that. I understand the turnover rate has gone down——

Mr. DONALDSON. The turnover rate has gone——

Senator SARBANES. Is that correct?

Mr. DONALDSON. It has gone down markedly, and that has been the result of the supplemental payments, salary payments, and it has been the result of the other benefits that we are bringing out. Our comparability with other Government financial institutions has been very helpful, as well as, I believe, the challenge of the work that is being done.

But we always will have, even though that departure rate has been way down, we always will have a certain number of positions that we have to fill. So, you know, we are putting water in the tank, but it is leaking out at the bottom.

We will have filled all of the new authorizations that we have by the end of this fiscal year, and I might just comment that the relative speed with which we have done that was impeded to begin with by the fact that we did not have fast hiring capabilities. In other words, we could hire lawyers quickly, but we could not hire accountants. You all and the Congress helped us get accelerated hiring capabilities. We did not get that until July of last year.

We also are very conscious of the quality of people, you know, not just going out and hiring anybody. We are having problems in the accounting area, and we are working to address those problems. We are working to address some virtual accounting approaches that would allow people to operate outside of Washington and so forth. We are getting great competition from PCAOB and so forth. The availability of accountants in the Washington area is low. So we are behind there, but we are on track for our hiring, and we will have completed our hiring by the end of this fiscal year.

Senator SARBANES. I will save my other questions for the next round. I think you should send a signal across the country to accountants that there are good opportunities here in Washington at the SEC, and in that regard, I also should note that many of the people in the private sector that come before us as witnesses or come to talk with us who are doing exceedingly well now in the private sector spent time earlier in their careers working at the SEC, and gaining the training and the knowledge that came with that experience.

I agree with you. I know you said to Wolfe that, "We have refused to hire employees simply to fill chairs but, rather, are focused on hiring the best and most appropriate people to fill these important positions." And I think that is a very important framework to be working within. But I do think it is important that we try to get staffed up to full level and that you not come to the end of this fiscal year and again not be able to utilize the resources which the Congress is providing.

Mr. DONALDSON. I totally agree with you, and I just want to reassure you that we are attending job fairs, we are advertising, we are across the country trying to recruit accountants as aggressively as we can. It is our number one priority.

Senator SARBANES. Okay. Thank you.

Chairman SHELBY. Senator Bunning.

Senator BUNNING. Thank you, Mr. Chairman.

I would like to go back to the board, the proposed changes that you have suggested. If a board is truly independent having 75 percent of its members to be independent board members, why cannot an independent board choose who they think would serve investors the best, be it an independent chairman or an interested chairman?

Mr. DONALDSON. Let me try and address that issue. I obviously heard your earlier comment on this, and I think it is an area where the structure of a mutual fund and the management company has an embedded conflict of interest. That embedded conflict of interest is that what is good for the management company is not always

good for the mutual fund shareholders. That is particularly true in deciding fees. Mutual fund shareholder directors are charged with a responsibility for fee setting. The chairman of a management company, when he is also chairman of a mutual fund, has a direct conflict of interest.

Senator BUNNING. Mr. Chairman, we are talking about three-quarters of the board being independent.

Mr. DONALDSON. I understand that, and let me go one step further. Some argue that an interested chairman; for example, the chairman coming from the management company, has all of the knowledge and so forth that an independent chairman would not have. My answer to that is that that chairman sits at the meeting, he sits and brings all of that expertise, 40 years of running a management company, knowing more about the business than anybody else, he is able to give his advice to that board.

But when it comes to conflict of interest and negotiating with yourself, I believe that you need an independent person who basically is in control of the agenda and basically has an independence—

Senator BUNNING. But that does not answer my question, sir.

Mr. DONALDSON. Pardon?

Senator BUNNING. My question is if it has three-quarters of independent board members, they have the option of hiring whoever they want to run the board. Are you telling me that three-quarters would always choose an interested party? Are you telling me that they are not independent?

Mr. DONALDSON. I am telling you that I believe that the dynamics of the way boards, and particularly the dynamics of the way mutual fund boards work, there is, in my view, a necessity for the independence of the chairman, and not defined by the board itself picking it.

Senator BUNNING. I have some other questions, and you are not answering my question. So, I am going to move on.

Do you know about the study, Bobroff's Mac study, that found that funds with interested chairs have performed better than those with independent chairs? In fact, I believe Putnam had an independent chair when they had all of their problems. Do you have evidence to the contrary showing that independent chairs perform and board chairs on mutuals perform better?

Mr. DONALDSON. Senator, I am aware of lots of studies that come to all a lot of different conclusions. I spent a number of years myself in an academic environment where studies were done. I believe we are in a totally new environment. I believe that the appraisal of independence or lack of independence back before we were making these changes is a totally different environment.

Senator BUNNING. We had this discussion the last time you appeared here about the independence of the SEC making the rules. Do you realize that Vanguard, T. Rowe Price, Fidelity would all have many people that would have to resign because of the rules that you make? How many investors have put their savings to these funds because of the reputation of these companies and their managers? I think that what you have proposed does more harm to the investor than good.

Mr. DONALDSON. I think that the expertise that the management company chairman, can still be available to the fund. If you bought the expertise of Mr. Johnson at Fidelity, 40 years in the business, 50 years in the business or whatever, he can still sit at the table. You are not taking him out of the room. He sits at the table, gives all his expertise, all of the reasons, if you bought his funds because of him, he is there.

When it comes to the power of independence, and the power of control and asking the tough questions, and controlling the agenda, that I believe there has to be an independent chairman.

Senator BUNNING. We have a difference of opinion.

Thank you.

Chairman SHELBY. Senator Reed.

Senator REED. I thank you very much, Mr. Chairman, and let me commend you, Chairman Donaldson, for the energy and insights you have brought to this task, and the results are obvious. Thank you for that.

Let me follow this independent chair inquiry. Just for the record, I think Senator Bunning asked the question about empirical studies and facts that you would use to make this recommendation. Are there studies that you can refer to or any empirical evidence that suggests that an independent head of the fund is better than a company head?

Mr. DONALDSON. What immediately comes to mind is the Mutual Fund Directors Forum, formed and led by former SEC Chairman Ruder, which has very strong views on this issue, very strong views from people who are practicing as independent directors about the necessity for independent chairmen. I admit that there is a difference of opinion on this, and it is not a silver bullet. Nothing that we do is a silver bullet.

What I am saying, at this time in our history of the mutual fund business, is that there should be a very clear separation. This relationship between a mutual fund and its management company is a very conflicted relationship, and it is different than a board of directors of a corporation with all different independent directors, lead directors, separation of chairman and so forth——

Chairman SHELBY. Mr. Chairman, how is it different?

Mr. DONALDSON. Excuse me?

Chairman SHELBY. How is it different?

Chairman DONALDSON. For several reasons. First of all is the profitability for the management company, in many instances, of things that are of no benefit to the shareholders. The use of commissions for research and so forth, a very ticklish area. The conflict relative to the fees charged and the obligations of the independent director to negotiate; you cannot negotiate with yourself. If I am chairman of the management company and I am chairman of a mutual fund, I cannot—no matter how honest I am—I cannot negotiate with myself on this issue, and I believe that we need an independent person doing that.

That does not directly address your comment, Senator, but it is a matter of personal feelings, it is a matter of judgment, having sat on a number of boards and having seen how they operate. I think you should have an independent chair.

Senator REED. Chairman Donaldson, under the current law, as I understand it, management contracts, underwriting agreements, 12b–1 plans, other decisions that may involve conflicts are voted on separately by the independent directors. Why is that not an appropriate response to this problem, particularly if you can identify those specific issues where, as you point out, an individual cannot negotiate with himself, even the fairest, most scrupulous ones.

Is that a possible alternative to this situation?

Mr. DONALDSON. All of those issues are ones that we have under examination right now, and we are trying to reach meaningful conclusions on them. I think that having an independent person who is not a shareholder of the management company, who does not have his personal livelihood in the management company, dependent upon the management company is very important. We need to have somebody who is not in that position, and I think we particularly need it at this time in history. I believe that shareholders will benefit from this, and I think they will welcome it. The additional expense of bringing an independent person into that role would be money well spent.

Senator REED. Mr. Chairman, I think you can recognize that there is an interest in this topic.

Mr. DONALDSON. I know.

Senator REED. And I think it is interest driven by both sides trying to find the best solution without harming the operation of these funds and then ultimately protecting the investors. But I think you, again, recognize that this is a topic that probably requires even further scrutiny, and I am sure you will do it.

Mr. DONALDSON. I obviously know that this is a controversial issue. The ICI is opposed. The ICI has been very active, and, I believe in many ways they have opposed this. I wish we had the time for you to sit down, and maybe we can do this before we make any final rules and you can talk to some of the independent directors who have been faced with this, who have sat in board meetings and get their views on it. I think they are almost unanimously of the view that it should be an independent chairman.

Senator REED. Thank you, Mr. Chairman.

Chairman SHELBY. Senator Sununu.

STATEMENT OF SENATOR JOHN E. SUNUNU

Senator SUNUNU. Let me follow up on that point. I apologize. I did not hear all of the answer that you provided, Mr. Chairman. I certainly heard the final part of the response which is you asserted your belief that an independent chairman would benefit shareholders.

My question is has the Commission begun the process of assembling the data and empirical evidence necessary to assert that claim that an independent chairman would directly benefit shareholders through either lower fees or better performance of funds?

Mr. DONALDSON. Well, we are always looking for more data, and we are always looking for empirical justification for what we are doing. I think that there are arguments on both sides of the equation in terms of data and data presentation. I do not think one study does it.

The judgment that I am putting forth here has to do with just that—judgment—and the sense of timing here in terms of the ills that the mutual fund industry has had. It is not a silver bullet. I just think it is one of many actions that will address the fundamental conflict that is there.

Senator SUNUNU. I genuinely believe you have done a fine job as chairman, and I do not want this to be taken the wrong way. But I think it is an important point in the Committee, and people who have come to these hearings are probably tired of me making this point. But judgment without data is a guess, and in fact all of the empirical studies that I have seen—and there have been several, and we have submitted them for the record already—have shown no relationship between having an independent chairman and fund performance or fees.

I believe if we are going to assert that it is a good thing, it will help, it will benefit shareholders, I think it is very important to assemble empirical evidence or data that will at least indicate the kind of benefits that we are trying to provide.

I think that is even more important, given that at least the political reason, the emotional reason, one of the emotional reasons that we have had so many hearings on this at this particular time is because of the so-called mutual fund scandals, the problems that we have seen that upset us all of fraud or a violation of existing law in mutual funds. In point of fact, many, if not most, of those scandals have occurred at funds with independent chairmen.

I just think we really need to provide some objective assessment that would indicate the benefits that we are trying to achieve.

Another question, a different topic. I am sure you are pleased about that.

[Laughter.]

I did not hear it explicitly stated in your testimony whether or not you thought that soft-dollar arrangements should or should not be banned.

Mr. DONALDSON. I did mention that we have a—

Senator SUNUNU. Task force, and that they are working hard—yes, I appreciate that.

Do you have a position on whether or not these soft-dollar arrangements should be banned?

Mr. DONALDSON. I think you have to refer to specific soft dollars and what they are being used for. We have proposed a rule that would not allow soft dollars to be used to promote the sale of mutual funds, and that is one of our rule proposals that is out for comment right now.

Senator SUNUNU. That relates to the distinction between qualified and nonqualified?

Mr. DONALDSON. No, it relates to the use of brokerage commissions to induce or compensate for the sale of mutual fund shares without the mutual fund shareholder knowing that those dollars are a hidden inducement to a supposedly impartial salesman.

The other part of soft dollars is the issue of what is in a commission rate. The typical rate now for execution and research is 5 cents a share, and typically 2 cents of that is for execution services, and 3 cents is for something else. And I believe that the disclosure, by the broker, of how much of that commission is for execution and

how much is for research is a very important thing that needs to be done and needs to be displayed by the mutual fund—how much they are paying for executions and then how much they are using soft dollars for research and where that money is going.

This gets into something we did not delve into, which is that money, in my view, should be available for third-party research people, not just the research coming from a large institutional firm. I think it would be a real mistake to eliminate the ability to pay for research from third-party people. Now, we need to define, under 28(e), what research is. I think that under that rule there is too loose a definition of research.

So it is not a simple "yea" or "nay" on soft dollars; it is what they are being used for.

Senator SUNUNU. I appreciate that point. I think what I hear you saying is that you want to make sure that, one, the rules are applied evenly, that we are not discriminating against independent research vis-à-vis proprietary research at full-service firms, and I think that is extremely important, especially given everything that the SEC has already done to encourage independent research. I appreciate your response, and thank you, Mr. Chairman.

Chairman SHELBY. Senator Corzine.

Senator CORZINE. Thank you, Mr. Chairman.

Mr. Chairman, I do not want to dwell on this independence of the chairman, but I suppose that definition of what independence means is also something that needs to be examined and fleshed out. Now, I think when you look at these studies, you have to ask yourself whether somebody is not necessarily an immediate family, but a family member, whether somebody is 2 years past retirement that had worked their whole career with an organization.

There are lots of ways to define independence, and I hope that being one that supports either an independent chairman or at least a lead shareholder in the board, that we do more to refine what the definition of what an independent shareholder is, in this context, so that we could get what I think is practical independence, as opposed to *pro forma* independence, which may be allowable under the current rules.

Do you, moving to another question, believe you have the authority to deal with the hedge fund issue in the context of how you described it in your testimony and presentation? Do you have the statutory authority to deal with that issue?

Mr. DONALDSON. I believe we do. Of course, this would be subject to a rule proposal to be viewed or vetted by the Commission itself, and that proposal being put out for comment and so forth, but I think we do have the authority to do that.

Senator CORZINE. Not here at this moment, but if I could have your legal people give us a statement on how you think that flows from the Investment Company Act and other places where you actually think you have that authority, I would like to understand that.

Chairman SHELBY. Senator Corzine, would you request for the whole record.

Senator CORZINE. Yes, please.

Mr. DONALDSON. Yes, we would be glad to provide that.

Senator CORZINE. Would you comment—particularly since I thought you were particularly articulate about saying it is very hard to negotiate with yourself if you are in a mutual fund company, and you are the chairman of the board, and you are negotiating the fees—we had a similar issue when we have mutual funds that have hedge funds, and you have a similar manager between the two, and one gets 1-percent management fee and the other gets an override or some performance-based fee, could you comment on the side-by-side elements of application of hedge funds inside a mutual fund.

Mr. DONALDSON. I think that this is an issue that is comparable to issues that were around the industry through the years that had to do with potential conflicts of interest by fund managers as to how they buy securities for their own account or whether there is front-running of the fund by insiders, et cetera. The side-by-side hedge fund issue is an extension of this. Shareholders are entitled, in my view, to the knowledge that a fund manager may also be running, or a fund management group may also be running, a hedge fund, where the compensation is much greater, the personal compensation is much greater.

I believe that there are several ways of getting at that. Number one is to disclose the compensation structure for managers, not their salaries and so forth, but how they are evaluated within the fund complex. And that, I believe, should be part of it, and we have work going on on that, I think that should be part of the disclosure process.

Second, I think there needs to be oversight, internal oversight, by the new officers that we are recommending be part of the mutual fund complex, to sit on that potential conflict in terms of the way shares are allocated when funds or investments are being made, who gets what first, the order of priority in that. Again, that is part of the whole process.

I think that, if where you are heading is to ask if mutual fund management companies should be prevented from running both hedge funds and mutual funds out of the same shop, I think that could cause a serious "brain drain," if you will, out of mutual fund management companies into the more lucrative independent hedge fund management positions.

Senator CORZINE. I would love to hear your comments—and I know my time has run out—the definition of research, as it relates to the whole soft-dollar question——

Mr. DONALDSON. Right.

Senator CORZINE. —I think at least looks to me like the nub of the question as opposed to—if you actually were able to deal with that, at some point, I would love to hear your views on that.

And turnover rate, which Senator Sarbanes talked about, what is the turnover rate now? What was it and what is it now?

Mr. DONALDSON. Turnover?

Senator CORZINE. The turnover rate of personnel. You said it slowed down.

Mr. DONALDSON. I think it is, right now, at 1.5 percent of——

Senator CORZINE. Annually?

Mr. DONALDSON. And it was as high, as little as 4 years ago, as 8 percent, and it has come steadily down, and it has come down in the last 2 years precipitously.

Senator CORZINE. Yes, 1.5 percent is pretty good for any organization I have ever heard of. If that is what it is, that is pretty terrific.

Chairman SHELBY. Thank you, Senator Corzine.

Senator Santorum.

STATEMENT OF SENATOR RICK SANTORUM

Senator SANTORUM. Thank you. First, I would like to agree with Senator Sununu. I think you are doing a fine job, and I agree with your testimony that we should not be rushing in here in the Congress to legislate in this area, that you are proceeding along—I do not agree with everything that you are proposing—but I think that the fact that you are moving forward and dealing with this in a forum which allows for experts in the industry and for the industry to participate, I think is a proper setting, before Congress rushes in with, at least from my perspective, this is really the best-informed approach on this issue. At least the actions that I have seen in the other body would indicate that to be the case.

I do want to add my voice in disagreeing with the issue on the independent chairman. I understand what you are trying to accomplish. I think Senator Bunning's point, which I think he made well, but I will remake it in a little different context, and that is if you have three-quarters of the board that are independent, if they are truly independent, then it should not be a concern that someone is trying to pull one over on this board.

If you do not believe they are independent or you do not believe independent directors are, in a mutual fund context, somehow or another strong enough to represent the interests of the shareholders, that is a different issue, and maybe we need to look at the qualifications of independent directors, I do not know, maybe the definitions of independent directors to make sure that they do have what is necessary to stand up and do what is in the best interests of shareholders.

If what you are saying is, traditionally—and I am intimating what you are saying—independent directors have really been pawns or puppets of the mutual fund company, well, then maybe we need to look at what independent directors really should be, as opposed to trying to, in my opinion, give independent—your proposal is to try to give independent directors more power and then, in a sense, take it away from them by limiting the choice of who they can put as chairman. That is a limitation on your power.

You are trying to give them power to be able to run this organization as they see best, and then you are limiting their power as to who they can select as chairman. I do not necessarily see how that comports.

I think the fundamental issue that you are trying to get at is are these people really independent, and that is what I think you should focus your attention on, not on who the chairman is. You can comment on that, but only if I get my other questions in.

The second point I want to make is on the issue of disclosure. Senator Corzine left, and I am going to ask his question because

that was the question that I had in mind. I agree with you on the issue of disclosure, as far as fees, and you went on to describe fees would be execution and research. Then you said the definition of "research" is loose. Can you suggest to me how you would tighten that definition.

Mr. DONALDSON. Yes. I think that the safe harbor that came in with 28(e) a number of years ago has gradually been expanded, if you will, and there are all sorts of things that are currently being paid for that are not really research. I do not want to get into anecdotal evidence, but whether it is newspaper subscriptions or whatever, there are a lot of things that are being paid for now that are not fundamentally investment research oriented, and it gets particularly confusing because of the rise of electronic research. Is it the software that delivers the research or is it the machine itself? I mean, there are a whole series of issues.

What I am saying is that I believe we can tighten up, and should tighten up, the definition of what is research. I think we can do that under 28(e) without changing 28(e).

Back on your question, and Senator Bunning's issue, on the independent chairman. I want to assure you that my view is just that—my view. I am one of five commissioners. I know that the commissioners are going to read this testimony. I know there are a lot of people on the other side of this issue. I just want to assure you that we will be as open as we can be, in terms of getting data, examining the issue and so forth.

I have taken a position on this. It is a personal, deeply held position, but again it will be an issue that will be brought up in a full Commission meeting, and I do not know where the other commissioners are on this issue.

It finally comes down to, as far as I personally am concerned, the issue of how the board agenda and how the dynamics and so forth of a board meeting work. A concept that is just hard for me to believe is that somebody who has an ownership position, and a salary and so forth, can sit in judgment on some of these issues. I believe that you must have an independent person there who is not the management company executive.

I am repeating myself now, but I will say it again. A management company executive who has all of that expertise can sit at the table and give all of that expertise to the board. It is just who controls the agenda that is of concern to me.

Senator SANTORUM. My time is up. Thank you.

Chairman SHELBY. Senator Carper.

Senator CARPER. Chairman Donaldson, let me just follow up on what Senator Santorum was saying, at least at the beginning of his question, with respect to independent chairmen or independent directors.

You mentioned that you are one of its five commissioners?

Mr. DONALDSON. Correct.

Senator CARPER. In the end, if you end up being in the minority of the decision on whether or not an independent chairman is to be required, and then the focus should return, rightly, to then what comprises independent directors.

Just talk with us a little bit about what kind of concerns that we should be mindful of, and you should be mindful of, in terms of what constitutes independent and what does not.

Mr. DONALDSON. A very good question. It is one that we are wrestling with right now. The definition of independence is somewhat limited. While it does not exclude uncles and aunts, and so forth, from being classified as independent, we are nevertheless concerned about those individuals.

We have found that we can get at that in certain instances by requiring disclosure; in other words, maybe uncle Joe, twice removed, is not technically precluded from being considered an independent directors by law. But we can get the mutual fund company to disclose uncle Joe's relationship to management in their prospectus, and I think that would be reason enough for them not to want uncle Joe, twice removed, to be an independent director but with the disclosure of the realtionship in a prospectus.

Senator CARPER. I once had an uncle Joe.

Mr. DONALDSON. Pardon me?

Senator CARPER. And he was a pretty independent cuss.

[Laughter.]

Mr. DONALDSON. But in terms of the issue at hand, I believe that it is, no matter how honest and full of integrity a person is, if he or she has spent their lifetime in a management company as an owner of stock, is paid by the management company, et cetera, I think it is very difficult for them to negotiate with themselves, to have the power of being a chairman. That is what I am talking about.

Senator CARPER. Do you have a similar view when it comes to a person being the chairman of the board, let us say, for General Motors or Dupont or some company like that, being CEO of a company, the person who is running the company and also being chairman of the board?

Mr. DONALDSON. This will seem to be an inconsistent position, but I think it is a different situation.

Senator CARPER. Just explain why.

Mr. DONALDSON. I am not one who believes that one suit fits all in the corporate world. I am not one that believes—I think there are certain great benefits from separating the chairmanship from the chief executive officership. I think there are certain times when you want to have a lead director fill that role. I think there are certain times when you want to have one person be both chairman and CEO. In that world, I would not be for one formula. I would be for giving flexibility to have a system that is pertinent at a particular time in history.

I think the relationship between a mutual fund and a mutual fund management company is a very different situation.

Senator CARPER. One of the violations that has been disclosed, in terms of abuses, I think, of customers of mutual funds is the violation of the hard 4 p.m. close.

[Laughter.]

I understand that in 1968 a requirement was established for, I guess, a time stamp. So we have had a requirement that was put in place maybe 36 years ago for a time stamp, the idea of which

was to try to make sure that people did not make purchases to the disadvantage of others. That obviously has not worked too well.

We are a lot better with technology today than we were in 1968. Is there some way to use that technology—whether it is with a time stamp or some other device—to be able to, you talked about the problems with 401(k)'s and how they might be disadvantaged, is there some way to use technology, whether it is a 21st century time stamp or not? What are your thoughts on that?

Mr. DONALDSON. Very definitely there are ways. Let me go back. There have been ways of abusing the old time-stamp method of doing things. Time stamps have been altered, tickets have been time stamped and then held back and then put in on a late trade. So there are ways of—modern ways—of changing that, making inalterable kinds of time stamps and so forth, high-technology ways of doing that. We are examining that right now.

There is the other issue of the unfairness, if you will, of people in different time zones and all of those issues, and I think the hard 4 p.m. suggestion by the SEC is under extensive examination. There are costs to some of these electronic ways of doing things, and we are going to try and come up with the best combination.

I am not sure you were here when I was commenting on this before, but this is one of the most difficult problems for us to meet with the right solution, a cost-effective solution, but we are working on it.

Senator CARPER. Good.

Mr. Chairman, has my time expired?

Chairman SHELBY. If you want to do another question, do it.

Senator CARPER. Thanks very much.

You have talked a little bit about soft dollars, and I was not originally aware of the practice where, as a mutual fund, I can contract with a brokerage house to execute trades and also give them some extra money that they would use to pay for independent research.

I am troubled by that practice. I do not think we are going to legislate on it, but tell me again what would you would have the SEC do with respect to that practice? I think I heard you say that you would establish a soft-dollar task force, one of the things that they are looking at was this.

Mr. DONALDSON. We are looking at the whole——

Senator CARPER. And the other half of my question, are there other soft-dollar practices that you are focusing on?

Mr. DONALDSON. Let me try and answer that in two ways.

First of all, under the safe harbor of 28(e), the definition of what can be paid for with brokerage dollars is too loose. Over a period of time, there are things that are being supplied to investment managers that are really not research. We could fill you in on that in detail.

The second part of this is the execution commissions that funds pay to the broker. That clearly can be broken down. There is an average now of 5 cents a share—the common average. What part of that is for execution, and what part of that is for research?

And what I am saying is that we need to get to a stage where the executing broker tells the institution that 2 cents of that 5 cents is for the execution, and maybe it is 3 cents if we position

some stock and gave an additional service. Therefore, you have, let us say, 3 extra cents. The institution should be able to direct perhaps a penny of that 3 cents to the executing broker for research in the big institutional brokerage firm and should be able to direct 2 cents to an independent research person, who is again providing real research and not *Wall Street Journal* subscriptions and so forth.

So, I guess what I am saying is that the funds—to get back to the mutual funds—in my view, should disclose to their customers how these brokerage dollars are being spent, that we are spending 2 cents times *x* million shares for executions, and we are spending 3 cents for research. And I believe that is the way to get at it.

Senator CARPER. Thanks very much.

Mr. Chairman, thanks for your indulgence.

Chairman SHELBY. Chairman Donaldson, it is troubling to a lot of us up here, you can tell, if you and the SEC were to mandate that a director be independent, although you are mandating or plan to mandate that 75 percent of all of the directors be independent. It looks to me like the directors should make that decision, who they want to be the chairman of their board, and that they should—and if they are independent, and if you define that properly, and I hope you would—make that decision because you are taking a lot of their power away from them to begin with, if you say you have got to have an independent director.

Let us say the most knowledgeable, the most worthy, the strongest person there was not independent, and everybody that was an independent—75 percent of the directors—would recognize that—they know they could fire the director or elect him or take him down—what would be wrong with the directors making that decision?

You see what we are asking, do you not?

Mr. DONALDSON. Yes.

Chairman SHELBY. I know you say that he has got an inherent conflict, but ultimately the directors should be looking after the mutual fund shareholders, should they not?

Mr. DONALDSON. This gets down to the definition of independence.

Chairman SHELBY. Absolutely.

Mr. DONALDSON. And it gets down to the attempt to define something by law. I think you can define away a lot of things that make somebody clearly not independent. I think it is very hard to define, by law, what true independence means, and I think that the nature of human relationships is such that independence is an ephemeral thing in the final analysis of what true independence is. And I think it is quite possible that you can have someone who qualifies as independent because of laws that have been written, but who really is not independent because of the relationships. That is what is in my head, based on the experiences that I have had.

Chairman SHELBY. We have these hearings, though, to discuss things like this.

Mr. DONALDSON. Obviously, it is a question that you all have.

Chairman SHELBY. For the Committee.

Mr. DONALDSON. It is a question that the Commission will look at very, very closely. Again, empirical evidence that you have or

that anybody has, we would like to have it. We are going to try and make the right decision, and a decision may be made that disagrees with my personal views. That is why we have five people on the Commission.

Chairman SHELBY. I want to touch on one more thing that I think we are in total agreement on this. We have talked about it, personally, and that is we should not legislate or regulate fees and that the fees should be set by the market, should they not?

Mr. DONALDSON. I can say that that is not only my opinion, but that is the unanimous opinion of the five commissioners, and this is where we differed in terms of the remedies brought against the mutual fund industry. We did not think that we should be legislating commissions. We thought the free market should.

Chairman SHELBY. You touched on the idea of disclosure, which is very important. But the information that the shareholders get in the mail regarding their fund, it has to be readable, it has to be understandable and so forth. What are you contemplating in this area? We had one hearing on that alone.

Mr. DONALDSON. We have a staff group, one of the study groups that we have put together, that is working on just that subject. If we are going down a plank of more, and more, and more disclosure, the question is does more disclosure disclose less because it is so complicated and so hard to understand, et cetera?

We have panels going now in three cities in the next couple of weeks, where we are bringing people together to examine some of our proposed actual physical ways of displaying some of this information and to see how useful it is to people.

We have a group going with the AARP, in which they are looking at alternative ways of displaying some of this information and helping us get it in a way that people can understand. And I think that is absolutely the other side of this equation. Disclosure can go just so far, and overdisclosure obfuscates, as opposed to disclosing. We are trying to get at that.

Chairman SHELBY. Thank you.

Senator SARBANES.

Senator SARBANES. Does Senator Bunning want to go?

Chairman SHELBY. If you want to go, go ahead.

Senator SARBANES. And then I will go.

Senator BUNNING. Chairman Donaldson, I quoted a study, and I have been informed by your staff that you do have that study—the Bobroff Mac Study on Mutual Funds and Independency.

Before you take a step that we may have to react to in the wrong direction, I would appreciate any data that indicates to the contrary that the SEC might have in regard to independency, independent directors and an independent head of the board. I would like to see what you are basing your opinions on, as the Securities and Exchange Commission, rather than what we are basing our own feelings on, and that is data.

I would like to see the data come from the SEC to the Committee, and I am requesting that you do that.

Mr. DONALDSON. We would be delighted to do that.

Senator BUNNING. Rather than a gut feeling that it just does not feel right, I would like to see the data that you base your facts on.

Mr. DONALDSON. I totally agree with that sentiment. I disagree with your characterization of my views on this as being an uninformed gut feeling.

Senator BUNNING. No, no. You obviously have studied the issue.

Mr. DONALDSON. What we try to do, before something is brought to the Commission, is analyze the pluses and minuses, and bring whatever data we have, whatever data we have on the other side, testimony by independent directors about the dynamics of the board room, all of this brought together, plus and minus, and then make a decision.

Senator BUNNING. Well, I hope your Commission, the Securities and Exchange Commission, is not like a lot of other commissions, that is chairman-dominated; in other words, that the four other people—

[Laughter.]

Mr. DONALDSON. You do not have any worry about that, Senator.

Senator BUNNING. Well, I worry about it because I have dealt with the Federal Reserve for the last 18 years, and I assure you that, in my opinion, the FOMC Committee has been chairman-dominated no matter who the chair was, and I have lived through three Chairs on the Federal Reserve.

So, please, because this is a very, very important issue, because the information that I have, in regards to mutual funds, and my experience over 25 years of selling and owning mutual funds, indicate to me that the owner-director or the person who is closest to the fund not only outperforms those that are independent chairmen, but also has a deeper commitment to make sure that that fund performs at the best number it can for its stockholders.

So, I cannot be more positive than I am in requesting your information and your data before you do something that there is going to be an unbelievable uproar on. So please do that for me.

Mr. DONALDSON. Sure. We absolutely will do that. The expertise, and the devotion and all that you imply for the management company officer who is also the chairman of the fund itself would be there sitting there giving that. The only difference would be that he would not be running the board meeting.

Senator BUNNING. Maybe he will be there.

Mr. DONALDSON. Absolutely. He is part of the 25 percent that can be there.

Senator BUNNING. The misfortune or the unfortunate part of this is that we may have a chairman who has been the number one producer and number one seller because of his performance as chairman, and I can go back and do some specific funds, but I am not going to do that. And the reason that investors really went into this fund is because of the performance that this man has had as chairman of this certain fund.

We have seen them advertised on television many times how well they have performed, although performance is not necessarily guaranteed for the future.

[Laughter.]

I know the disclosure. So, please, let us not have to fire somebody who is doing one great job as chairman of the board of some mutual fund just because the SEC feels and has data that they feel makes a change necessary.

Thank you.

Chairman SHELBY. Senator Sarbanes.

Senator SARBANES. Thank you very much, Mr. Chairman.

Chairman Donaldson, first of all, we did a little research in the interim. The quote that I was referring to, which is at the entrance to the SEC's public meeting room from Chairman William O. Douglas, subsequent Supreme Court Justice, says, "We are the investors' advocate." "We are the investors' advocate," is really the charge for the SEC.

I want to again commend you. I am just looking at your mutual fund initiatives, and some have been finalized, but most are in the process of being considered. Amendments to rules governing pricing of mutual fund shares, late trading, disclosure regarding market timing and selected disclosure of portfolio holdings, compliance programs of investment companies and investment advisers, enhanced disclosure of break-point discounts by mutual funds. Also, concept release on mutual fund transaction costs, new investment company governance requirements, investment adviser codes of ethics and insider reporting of fund trades, confirmation requirements and point-of-sale disclosure requirements for mutual fund transactions, enhanced mutual fund expense and portfolio disclosure, and improved disclosure of board approval of investment advisory contracts.

I do not know, there may have been additional ones that have been added recently, but that I think is a very active and vigorous agenda on the part of the SEC, and I want to commend you for it.

Once you put these things out for comment, everything comes in upon you, and I understand that. We, on occasion, have a similar experience here, and obviously you have to work through these things and end up doing what you think is right, and there is a lot to be done.

On March 12, 2003, Mr. Haaga, representing the ICI, testified before the House Financial Services Committee, March 12, 2003—just over a year ago. This is what he said, in part:

"The strict regulation that implements these objectives has allowed the industry to garner and maintain the confidence of investors and also has kept the industry free of the types of problems that have surfaced in other businesses in the recent past. An examination of several of the regulatory measures that have been adopted or are under consideration to address problems that led to the massive corporate and accounting scandals of the past few years provides a strong endorsement for the system under which mutual funds already operate."

Now, obviously, either people did not know what was going on, there was a complacency because all of these practices now that are coming out, most of which are the subject of your proposed rulemaking, obviously have raised questions about what confidence investors can have, and they need to be corrected or they need to be cleaned up, and my perception is that is what the Commission is working to do, and I am supportive of your efforts to do that.

I think you need to carry through on it. You put out the proposed rules. You get the benefits of the comments in order to work through to an even better substantive decision, but I do not think the Commission, I do not expect the Commission would back off

simply because there is a lot of pressure if they perceive that what they are trying to accomplish is the appropriate thing to do.

Now, Chairman Shelby and I received a letter, which I think we have sent down to you, and you have had a chance to look at, from the consumer groups—Consumer Union, Consumer Federation of America, Consumer Action, and Fund Democracy—raising a number of questions. They say the SEC has responded effectively to the majority of issues raised by the recent mutual fund scandals. They say, "Because of that, Congress finds itself in the enviably position of not needing to pass sweeping mutual fund reform legislation."

They do then address some issues, though, that they think remain outstanding, which the Congress out to take a look at.

I do not know if you have had a chance to examine that letter.

Mr. DONALDSON. I saw that letter yesterday.

Senator SARBANES. I would be interested in your reaction, if you had a chance to formulate one. Then they go on and also say, "Almost as important, we urge the Committee to continue to monitor SEC implementation of its proposed mutual fund rules to ensure that it does not waiver in its commitment to strong pro-investor reforms."

And I, Mr. Chairman, Chairman Shelby, I think we obviously need to do that monitoring.

Chairman SHELBY. We will do it.

Senator SARBANES. Not that I have reason to believe that the Commission will waiver in its commitment to strong pro-investor reforms, but simply as carrying out our responsibilities. In fact, I hope the Chairman will come away from this hearing refortified in his determination to carry through on strong pro-investor reforms.

Do you have, as yet, any view on these suggestions within the letter?

Mr. DONALDSON. That letter came across my desk yesterday, and I jotted down a few reactions to it that I had. These are my reactions to it. We are going to take a good hard look at what they said.

Senator SARBANES. I thought it was, I mean, these are responsible organizations, and I thought it was a thoughtful responsible letter.

Mr. DONALDSON. I have no doubt of that. The title of the letter is, "Cost Competition," and they say that they advocate that "Congress mandate better mutual fund cost competition." Many of the ideas that were exposed in that letter are thoroughly addressed in the SEC's concept release on transaction costs, and I would suggest this consumer group read that release.

It also says, "although transaction costs are not taken into account in computing a fund's total return, there is concern that investors would not fully understand the impact of transaction costs because those transaction costs are not separately disclosed in a fund's expense table." We are working on that. We are working on the correct disclosure of that.

The letter also advocates better disclosure at the point of sale. Again, the SEC has a rulemaking proposal right now pending that will provide, for the first time, point-of-sale disclosure about certain costs and conflicts.

I could go through that letter point-by-point. Basically, it was a letter that seemed to not have been informed by a reading of our

agenda that is out there and what we are doing right now. We will answer that letter and provide copies of our answer to you, but our bigger point is that we are not going to back off in any way.

And we do not view the 10 proposals that we have out there—we do not view that as the end of what we are doing. We have these teams working now that are going to go into the next step here—things we do not catch now, the next step, year after year, after year. I want to assure you that that is what we are working on, and that is what we are going to do.

Senator SARBANES. Are these teams that you keep referring to, internal teams at the SEC made up of SEC staff; is that correct?

Mr. DONALDSON. They are representatives of the different divisions who bring different dimensions to bear. Studying this, they have the right to talk to people outside and to gather any information and to come up with some recommendations for us.

Senator SARBANES. When would you expect that the SEC will have finished its work, at least on the rules that have been put out, leaving aside further rules that you might propose as a consequence of further examination or as a consequence of the reports of these task forces.

Mr. DONALDSON. We have two rules that were put out that have now been adopted by the SEC. They were adopted in December and February. That had to do with investment adviser compliance programs and shareholder reports and portfolio disclosure. We have 10 proposed rules out there now, and the beginning of the proposal of those rules started in December, and it ended on March 11. We have scheduled times, if you will, for bringing these rules up for final approval. That schedule may change, depending upon the state of our deliberations.

I anticipate that by hopefully the end of the summer or the beginning of the fall we will have acted on most of these proposals. I cannot guarantee that on all of them. And, if we are delayed, it will be because we are trying to get a better fix, if you will. But I would say that certainly by year end, hopefully, by the fall, and possibly by the end of the summer.

Senator SARBANES. Does the industry perceive the necessity of making significant changes in order to restore investor confidence or do you perceive them as resisting this and taking an attitude: Well, nothing is really wrong—there were a few outliers, but aside from that, we just want to go on doing things as we always did things?

Mr. DONALDSON. No, I do not think that is true. I think if you can talk about the industry, I think the industry is cooperating. I think the trade associations are cooperating. We do disagree on a few things. A couple of their recommendations we do not think are correct, but, by and large, I think there is a new attitude out there, and I think that it has been a very cooperative attitude.

Now, that is not to say that there are not intensive lobbying efforts mounted against some of the things that we want to do. We recognize that as part of the way the process works. But I think, generally speaking, there has been great cooperation.

I might also say, because it is said too little, that, although there were some shocking things that happened in terms of this late trading, market timing, and selective disclosure, and although

there was the front office of the funds telling us they were trying to cure this stuff when the back office was making deals, and that is shocking, there are other funds that have not been doing this at all, that are very well run, that have controls, et cetera, and I think they deserve a pat on the back.

Senator SARBANES. Yes, I think that is a very apt observation because there are a number of funds that their practices have not been brought into question.

Mr. DONALDSON. Exactly.

Senator SARBANES. And that is, of course, highly commendable.

Mr. DONALDSON. I just want to say that publicly. But I think overall, in terms of your observation or your question, I think that a new day is afoot here, and I think there is new attention being brought to these issues. I think there are people in the industry who are as upset as we are and you are by what has happened in the industry, and they are doing everything they can to not only change their own organization, but also working through other organizations to bring about change in the whole industry.

Senator SARBANES. Thank you, Mr. Chairman.

Chairman SHELBY. Chairman Donaldson, you certainly realize, and we do, too, that your chairmanship of the Securities and Exchange Commission is at a critical time. I want to say again that we appreciate your appearance here again. You have spent a lot of time with us, and I am sure in the future we will be spending a lot of quality time together as we continue our oversight of what your regulations will bring forth, how they work.

We are certainly not ruling out legislation in the future, but we are not ruling it in today either because we want to see what the SEC does, how it works, and then we will work with you and see if there is something in the months to come. This is a short year, legislatively, as we all know, but we appreciate what you are doing, the start you are doing, the challenge you have, and you are always welcome here, and we will get together again.

Mr. DONALDSON. Thank you, Mr. Chairman.

Chairman SHELBY. The hearing is adjourned.

[Whereupon, at 12:13 p.m., the hearing was adjourned.]

[Prepared statements, response to written questions, and additional material supplied for the record follow:]

PREPARED STATEMENT OF SENATOR JON S. CORZINE

Thank you, Mr. Chairman. Mutual funds are the primary means for investors to participate in the market. Approximately 95 million Americans invest in mutual funds, and investments total near $7 trillion dollars. The industry, one of our oldest and most revered, is entrusted by Americans with their dreams of retiring comfortably or of paying their children's college tuition or of buying a first home. In addition to being a force for economic growth and wealth creation, the mutual fund industry has been, for decades, a standard-bearer for ethical behavior, investor protection, and strong oversight and governance in our capital markets.

But as we have witnessed over the past year, this industry has found itself at the center of scandal after scandal. To be sure, a great deal of confidence has been lost due to the litany of allegations of fraud and mismanagement, corporate governance failing, financial conflicts of interest, and other abusive practices. Last fall, Senator Dodd, the Ranking Member of the Securities Subcommittee, and I introduced S. 1971, The Mutual Fund Investor Confidence Restoration Act of 2003. This legislation aims to protect the millions who invest in these funds by seeking to:

- improve mutual fund governance, internal controls, and ethical compliance;
- enhance cost, fee and other disclosures to shareholders;
- eliminate financial conflicts of interest where possible, and make shareholders aware of where potential others may exist;
- prevent abusive mutual fund practices, such as late trading and market timing and;
- strengthen the oversight of the industry.

The measures included in the legislation were a response to the scandals that arose from investigations by the SEC and the office of State attorney generals. To their credit, the SEC has been aggressively pursuing changes in the culture of the mutual fund industry through an aggressive approach at proposing regulatory initiatives.

But while their actions are important, we must consider what more—if anything—can and should be done. And we should give consideration to whether codifying these rules will prevent an overreaction during future shocks or scandal.

In short, Mr. Chairman, it is legitimate to consider what role—if any—Congress should play in this effort. I personally believe there is a role. As a result, shortly after we return from recess, Senator Dodd and I will be introducing a new version of our mutual fund legislation. The bill will include some of the fund governance, transparency and disclosure, and other provisions included in S. 1971. But it will also address some of the complex issues that lead to conflicts of interests. Some of those can be found in the financial arrangements between fund complexes, investment advisers, broker-dealers, and other intermediaries to promote the sale and distribution of the funds.

We will be addressing the issue of directed brokerage, soft-dollar arrangements, and revenue sharing, just to name a few. Additionally, we will address the SEC's "hard 4 p.m." proposal, and consider an alternative that will not disadvantage certain investors, particularly 401(k) and west coast investors, but will provide the SEC with the assurance that these intermediaries have controls, compliance systems, and audit trails in place to prevent abusive market timing and late trading.

Mr. Chairman, there is no doubt that real reforms are needed. Thankfully, they are already on the way. I commend the efforts of the SEC, Chairman Donaldson, and his staff for their aggressive approach toward promoting these much-needed reforms. But while the reforms they have initiated are important, I am not sure that they vitiate the need for statutory action, especially since in some areas, like soft dollars, the necessary changes will require ultimately statutory fixes.

Mr. Chairman, I look forward to working with you, and the other Members of this Committee, in the effort to fashion these reforms. And, I again thank you for your thoughtful and deliberate approach to these important matters.

PREPARED STATEMENT OF SENATOR MICHAEL B. ENZI

Thank you Chairman Shelby for holding this series of oversight hearings on the mutual fund industry. It is a very similar approach to the one the Committee took with the Sarbanes-Oxley Act. The mutual fund industry operates unlike any other financial service industry. The series of hearings has helped us to understand the industry as well as being able to understand how the scandals were able to happen.

Under the direction of Chairman Donaldson and the rest of the Securities and Exchange Commission, I believe that we are on the proper course to reforming the mu-

tual fund industry. I cannot recall a time when the Commission has acted in a more timely and comprehensive way to restore investor confidence. The Commission has undertaken a variety of regulatory, enforcement, and examination initiatives to correct the significant problems and lax oversight of an industry that millions of investors rely upon for their future retirement and investment needs.

Chairman Donaldson, in your capacity as Chairman of the SEC during the past 14 months it is very likely that you have been more active and productive than perhaps the last couple decades of SEC Chairmen. The extremely hard work that you, the Commissioners, and the staff have undertaken to put the SEC back on track should be recognized. I also realize that your work on the many issues pending before the Commission is not yet done.

While I applaud the Commission with moving forward quickly on the regulatory reforms, the many hearings before us have given me a greater insight as to how the mutual fund industry has developed over the years. What may be considered unique or unusual practices to typical corporation or Wall Street firms, may in fact be practices that are an integral part of the operations of the mutual fund industry. Accordingly, I urge the Commission to carefully consider proposals that would impose a "hard 4 p.m. close" for the placement of mutual fund orders and the mandatory requirement of an independent chairman. I strongly believe that alternatives are available that be in the best interests of investors and would not change the dynamic nature of the mutual fund industry.

Being from a western State, I have heard from constituents that the hard 4 p.m. close proposal would place western State investors at a great disadvantage to their eastern State neighbors. The proposal also would pit investors that place mutual fund orders through third parties, such as employer-sponsored retirement plans, against those who place orders directly with mutual funds. I know that the Commission can find a solution that will not place certain investor groups over others.

In addition, I understand that the Commission has established a task force to study the soft-dollar issue. I urge the task force to commence its review of this area in the very near future. We have heard a great deal of testimony before the Committee that there are inappropriate uses of soft dollars, however, a complete ban on soft dollars would disproportionately effect small, independent research firms. The findings of the Task Force are essential in order to determine whether legislation is necessary in this very important area.

Recently, you have given speeches and testified before Congress on the Commission's upcoming proposal to regulate hedge funds. I am very concerned that the Commission will expend resources on regulating hedge funds when it has not yet finished Phase 2 of the Investment Adviser Registration Depository for the oversight of investment advisers. In addition, I would hope that the Commission is fully confident that it can oversee and examine the mutual fund industry prior to expanding its oversight into other areas.

As we know, the oversight of the mutual fund industry by the Commission has not been as stringent or as thorough as it should have been in the past few years. I do not want to give false hope to investors that the Commission can further tax and stretch its resources without doing a sufficient job on its primary oversight of the mutual fund and investment adviser industries. Millions of retail investors are counting on you to do the right thing to safeguard their retirement and investment savings.

Thank you again Chairman Donaldson for appearing before us today.

Mr. Chairman, thank you again for taking a careful, thoughtful, and thorough oversight review of the mutual fund industry. I have greatly benefitted from all of the witness' testimony.

PREAPRED STATEMENT OF WILLIAM H. DONALDSON

CHAIRMAN, U.S. SECURITIES AND EXCHANGE COMMISSION

APRIL 8, 2004

Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee, thank you for inviting me to testify today at your tenth hearing on mutual fund issues since late trading and market timing abuses came to light last fall. The breadth of your hearings have clearly and effectively illustrated the complexity of the issues the Commission is facing in addressing problems in the mutual fund industry. The hours upon hours that you and the Committee have spent performing critical oversight, and the testimony from witnesses representing all sectors and aspects of the problem, have been immensely valuable as the Commission works to

tackle these issues. I thank you and I commend you for your thorough and thoughtful approach.

Like you, I am outraged by the conduct that has come to light in the recent mutual fund scandals. In large part, I believe that the industry lost sight of certain principles—in particular, its responsibility to millions of investors who entrusted their life's savings in this industry for safekeeping. As I said last fall when I testified before you, and I believe it bears repeating, these mutual fund investors are entitled to honest and industrious fiduciaries who sensibly put their money to work for them in our capital markets. Investors deserve a brokerage and mutual fund industry built on fundamentally fair and ethical legal principles. This has been the Commission's urgent and guiding mission as it pursues an aggressive mutual fund reform program to identify and address a range of problems in the industry. The Commission has made significant progress, and will continue to move aggressively to track down and pursue wrongdoers, while expeditiously considering and adopting the outstanding mutual fund rule proposals.

As you have seen through your hearings, and we have witnessed through our rulemaking process, there is a wide variety of views among knowledgeable experts as how best to address mutual fund oversight—views that very often conflict with one another, particularly among competitors. That is why our notice and comment process, which Congress so wisely required in Commission rulemakings, is of infinite value to us and to the final product. In a deliberate, structured format, we benefit from a wide spectrum of views and opinions as to how to strengthen our proposed rules and regulations, the practicalities of implementing those rules and regulations, and alternative approaches to address the underlying goals of our proposals.

As you requested, I will address the Commission's recent initiatives to respond to the specific problems of late trading, market timing, and selective disclosure abuses. I will also address what the Commission has done and is continuing to do to strengthen the mutual fund regulatory framework overall, as we work to prevent any future breakdowns in the industry.

With more than 91 million Americans invested in mutual funds, representing almost half of all U.S. households, and a combined $7.5 trillion in assets, mutual funds are unquestionably one of the most important elements of our financial system. Investor protection is a top priority at the Commission. We are focusing our attention on pursuing an aggressive program to identify and address a range of problems and challenges in the mutual fund industry—challenges such as strengthening the governance structure of mutual funds, addressing conflicts of interests, enhancing disclosure to mutual fund shareholders, and fostering an atmosphere of high ethical standards and compliance within the industry.

Appropriately, the Commission and its staff have been extraordinarily busy addressing challenges with particular focus on addressing the specific problems of late trading, market timing, and selective disclosure abuses. In my testimony, I will outline: (1) our aggressive rulemaking agenda—which has immediately tackled late trading and market timing abuses; and our extended efforts to address broader structural problems in the mutual fund regulatory framework; (2) our vigorous inspection and enforcement efforts; and (3) the restructuring of the Commission's overall internal functions and operations to better assess and anticipate risk, particularly vis-à-vis the mutual fund industry.

The Commission's Rulemaking Initiatives

Last month, as part of your hearing series, Paul Roye, the Director of the Commission's Division of Investment Management, testified regarding the aggressive regulatory agenda the Commission has undertaken to combat late trading, market timing, and related abuses. In addition, he outlined the aggressive overall regulatory agenda to: (1) improve the oversight of funds by enhancing fund governance, ethical standards, and compliance and internal controls; (2) address or eliminate certain conflicts of interest in the industry that are potentially harmful to fund investors; and (3) improve disclosure to fund investors, especially fee-related disclosure. In each of these areas the Commission has moved swiftly to propose rules and to vet them through our notice and comment process and, in many instances, through meetings with relevant interested parties. We also are moving promptly to craft final rules but, because of the complexity associated with some of our proposals—such as our proposal on late trading—we may take additional time before finalizing our proposed rules. More important than acting quickly is making sure we get it right. Let me briefly describe our proposals in each of these areas.

Late Trading & Market Timing

Investors rightfully assume that mutual fund managers and fund directors put the investors' interest first. When the late trading and market timing abuses came to light, it was clear that many of these investors had been let down, as some of those charged with protecting investors had willfully disregarded their responsibilities to act for the benefit of their investors. To put an absolute halt on late trading, the Commission proposed the "hard 4:00" rule. This rule amendment would provide for a secure pricing system that would be largely immune to manipulation by late traders by requiring that orders be placed with the fund or its primary transfer agent or clearing firm by the time set by the funds.

Typically, funds price their shares at 4 p.m. eastern standard time. Investors submitting orders before 4 p.m. receive that day's price; investors submitting orders after 4 p.m. get the next day's price. If an investor can place an order to buy or sell fund shares after 4 p.m., but still receive the price set at 4 p.m., that investor can profit from new information in the marketplace at the expense of other fund shareholders. Under the current system, various intermediaries, including some pension plan recordkeepers—some of whom are not registered with the Commission—can receive the orders by 4 p.m. We know that the current system has failed because intermediaries allowed certain, select shareholders to receive the 4 p.m. price, even though their orders were placed after 4 p.m.; consequently, we needed to devise a new system to minimize the possibility of this abuse in the future.

To date, the Commission has received more than 1,000 comment letters on this proposal, many raising concerns about how the proposal might adversely impact certain fund investors such as 401(k) plan participants and investors in earlier time zones across the country. As an alternative to the proposal, some have advocated a system of controls that would better prevent and detect late trading; others have recommended the use of more sophisticated technology to create tamper-proof time stamping of trade tickets that would help eliminate, or at least better detect, late trading. The staff is analyzing this information to determine whether there is an effective alternative to the hard 4:00 rule proposal that would not disadvantage certain investors and would not distort competition in the marketplace. It may very well turn out that we adopt a combination of some of the alternatives that have been presented to us during the notice and comment process. Again, the hard 4:00 rule proposal illustrates the effectiveness of the Commission's rulemaking process, whereby we, and indeed the investing public, are the beneficiaries of a wide range of views and perspectives, and possible solutions.

To address market timing, especially so-called "arbitrage market timing," the Commission has stressed that "fair value pricing" is critical to reducing effectively or eliminating the profit that many market timers seek and the dilution of shareholder interests. However, because fair value pricing can be subjective, the Commission also intends to continue to monitor funds' fair value pricing practices and has proposed improved fair value pricing disclosure; enhanced disclosure regarding a fund's antimarket timing policies and practices; and, to reduce the possibility of abusive market timing, that funds impose a mandatory 2 percent redemption fee when investors redeem their shares within 5 days of purchase. If the Commission moves forward with adopting the mandatory redemption fee proposal, I feel that it must contain exceptions—for example, exceptions for individual investors who have suffered an unforeseen hardship and for money market funds and funds that specifically cater to market timers. Along with the mandatory redemption fee, the Commission also proposed a process that, for the first time, would give mutual funds a weekly pass-through of buyer and seller information from intermediaries. That process, which is often lost in discussion, is a critical piece of the proposal that would allow funds to identify market timers and apply the funds' antimarket timing procedures.

Fund Governance, Ethical Standards, and Compliance

In an effort to enhance oversight of the industry, the Commission proposed a comprehensive rulemaking package to bolster the effectiveness of independent directors and solidify the role of the fund board as the primary advocate for fund shareholders. The proposal would enhance the independence of fund boards by including a requirement for an independent board chairman and a board comprised of 75 percent independent directors. Board and chairman independence is just part of what we are considering to restore overall accountability to the fund board.

In an effort to reinforce the fundamental importance of integrity in the investment management industry, the Commission recently proposed that all registered investment advisers adopt codes of ethics. The code of ethics would set forth standards of conduct for advisory personnel that reflect the adviser's fiduciary duties, as

well as codify requirements to ensure that an adviser's personnel comply with Federal securities laws and report their securities transactions.

In the area of improving compliance and the oversight of fund boards, the Commission, in December, adopted a rule requiring that funds and their investment advisers have comprehensive compliance policies and procedures in place, including appointing a designated chief compliance officer. In the case of a fund, the chief compliance officer would be answerable to the fund's board and could be terminated only with the board's consent. This rule will have a far-reaching, positive impact on mutual fund operations and compliance programs by ensuring that funds have a primary architect and enforcer of compliance policies and procedures for the fund and, perhaps more importantly, a compliance officer who can be the eyes and ears of the board of directors. This requirement will provide fund boards with a powerful tool to identify and prevent misconduct that could potentially harm funds and their shareholders. Funds must begin compliance with this final rule by October 2004.

Conflicts of Interest

In addition to taking steps to enhance mutual fund oversight and ethical standards, the Commission has also undertaken a series of initiatives aimed at certain conflicts of interest that exist now between mutual funds and those who distribute fund shares. For example, the Commission voted to propose an amendment to Rule 12b–1 to prohibit the use of brokerage commissions to compensate broker-dealers for distribution of a fund's shares. This would eliminate a practice that potentially compromises best execution of a fund's portfolio trades, increases portfolio turnover, and corrupts broker-dealers' recommendations to their customers.

At the same time, the Commission sought comments as to whether other changes should be made to Rule 12b–1 or even if it should propose to abolish the rule altogether. For instance, should we continue to permit 12b–1 fees to be used in lieu of a front-end sales load? Should distribution costs be taken directly out of a shareholder's account rather than out of fund assets, so that each shareholder pays his or her own distribution related costs? Should long-term shareholders even be bearing distribution costs? We are anxious to review the comments we receive on these questions as we move forward in our reconsideration of Rule 12b–1.

The Commission also has proposed improved disclosure regarding a portfolio manager's relationship with the fund. The proposals include disclosure regarding the persons managing the fund, the structure of portfolio manager compensation, ownership of shares of the funds that a manager advises, and comprehensive disclosure of specific investment vehicles, including hedge funds and pension funds that are also managed by a fund's portfolio manager.

Disclosure to Fund Investors

Improved disclosure—particularly disclosure about fund fees, conflicts, and sales incentives—had been a stated priority for the Commission's mutual fund program in the months before the trading abuses came to light. Consequently, the Commission took steps to significantly improve the information required for individual shareholders. First, the Commission adopted a requirement that shareholder reports include dollar-based expense information so that investors can easily compute the dollar amount of expenses paid on their investment in a fund. This is an important step in providing shareholders with critical information about their mutual fund investments. Some have questioned whether we should have required more information—that is individualized account information to each shareholder. While the staff and the Commission considered this alternative, we were convinced that the dollar-based expense information that the Commission ultimately adopted was the better course, as it allowed for comparability. We have ongoing efforts to continue examining the entire mutual fund disclosure regime to see if it is as good as it can be; however, with respect to this particular rule—which will go into effect in July—I firmly believe we must give the rule a good chance to operate before we contemplate changing it.

In other efforts to improve disclosure for investors, the Commission has:

- issued a concept release on methods to calculate and improve the disclosure of funds' portfolio transaction costs;
- proposed to make more transparent in shareholder reports how fund boards evaluate investment advisory contracts;
- proposed new fund confirmation forms and new point-of-sale disclosure that would greatly enhance the information that broker-dealers provide their customers in connection with mutual fund transactions, and highlight the conflicts that broker-dealers face in recommending mutual fund investments; and

- proposed improved prospectus disclosure to address the wide-scale failure on the part of broker-dealers to provide appropriate breakpoint discounts on front-end load mutual fund purchases.

While neither I nor my fellow Commissioners have finalized our positions regarding each of these rule proposals, we all agree that the areas they address are of critical importance to the protection of mutual fund investors. The staff is reviewing and analyzing the comments received on these various rule proposals in order to finalize its recommendations for the Commission's consideration in adopting the rules. We have received comment letters from fund shareholders, Senators, Congressmen, fund complexes, directors, officers, and broker-dealers to name just a few. While not all commenters have agreed with the staff's proposals, just as the Commissioners do not always agree with one another, a healthy, intellectual, reasoned debate will better inform the staff and improve the final product as we move toward final adoption of these rules.

And, just as we embarked on an aggressive agenda to propose these rules, we will be just as aggressive in our agenda for considering the final rules. This spring and summer, the Commission will be considering all of these outstanding mutual fund rulemaking proposals: market timing disclosure, breakpoint disclosure, the fund governance package, the investment advisers code of ethics rule, disclosure regarding the factors considered by the fund's board in approving the advisory contract, the proposed amendments to Rule 12b–1, the hard 4:00 close, portfolio manager disclosure, the mandatory 2 percent redemption fee and flow through of information between funds and intermediaries, and new confirmation form and point-of-sale disclosure. However, while it is important that we consider adoption of these rules in an expeditious manner, it is equally important that we give interested parties an opportunity to comment and our staff sufficient time to consider fully possible unintended consequences and vet alternative approaches to our proposals so that we adopt the final rules that best address the problems we seek to solve.

Inspections and Enforcement Efforts

Complementing our regulatory reforms are vigorous inspection and enforcement programs for detecting wrongdoing and enforcing the Federal securities laws. As I have mentioned before, the mutual fund abuses that we have witnessed represent a fundamental betrayal of American investors, and the Commission has punished, and will continue to punish, the malefactors swiftly and with every tool available to us. The detection and enforcement piece of the Commission's agenda relating to mutual funds currently is focused primarily on four types of misconduct, each of which may show that the interests of financial services firms or their employees were being placed above the interests of investors.

The first area of priority is late trading and abusive timing of mutual fund shares. Since the disclosure of these practices last September, the Commission has conducted a broad investigation and has brought numerous enforcement actions charging hedge fund managers, broker-dealers, investment advisers, and their associated persons with engaging in such abuses to the detriment of fund investors. While our examinations and investigations are ongoing, the enforcement actions we have brought thus far have involved some of the most well-known names in the mutual fund industry, including Putnam Investments, Invesco Funds Group, Alliance Capital Management, Massachusetts Financial Services, FleetBoston Financial, and Bank of America. The settlements obtained by the Commission in several of these cases have resulted in significant corporate governance and compliance improvements, as well as substantial payments that will be used to compensate harmed investors.

Among these recent settlements was the Commission's order against Massachusetts Financial Services, Inc. (MFS). On February 5, 2004, the Commission filed a settled enforcement action against MFS, its chief executive officer, and its president and chief equity officer, for violating the Federal securities laws by allowing widespread market timing trading in certain MFS mutual funds in contravention of those funds' public disclosures. The Commission censured MFS and ordered it to pay $225 million, consisting of $175 million in disgorgement and $50 million in penalties. The Commission's Order further requires MFS to undertake certain compliance and mutual fund governance reforms designed to enhance the independence of mutual fund boards of trustees and strengthen oversight of MFS's compliance with the Federal securities laws.

For their roles in the misconduct, the Commission prohibited MFS's CEO and president from serving as an officer or director of any investment adviser and from serving as an employee, officer, or trustee of any registered investment company for 3 years. In addition, the Commission's order places certain restrictions on the duties the CEO and president can perform during that period. The Commission also sus-

pended both the CEO and president from association with any investment adviser or registered investment company for 9 months and 6 months, respectively, and ordered each to pay a penalty of $250,000 and disgorge over $50,000 in ill-gotten gains derived from MFS's market timing practices. All of the money paid by MFS, its CEO and its president will be distributed to harmed shareholders.

Our second area of examination and enforcement priority focuses on mutual fund sales practices, including fee disclosure issues in connection with the sale of mutual funds. In particular, we are looking at what prospective mutual fund investors are—or are not—being told about revenue sharing arrangements and other incentives provided by mutual fund companies to broker-dealers selling their funds. Customers have a right to know how their broker-dealer is being paid to sell a particular fund. And when these payments are being made from fund assets, customers should understand that their own investment dollars are being used to foot the bill for the mutual funds' premium "shelf space" at the selling broker's office. Such fees may increase costs to investors as well as create conflicts of interest between investors and the financial professionals with whom they deal. The Commission brought the first case targeting these undisclosed payments in November 2003 against Morgan Stanley. In settling the matter, Morgan Stanley agreed to pay $50 million in disgorgement and penalties. We are continuing to examine and investigate industry participants for similar practices. The potential disclosure failures and breaches of trust spotlighted in the Morgan Stanley case are not necessarily limited to Morgan Stanley, or even to broker-dealers.

The Enforcement staff is also looking very closely at the role and responsibilities of mutual fund companies themselves in these arrangements. In fact, last week, the Commission filed a settled action against MFS related to the company's use of mutual fund assets—namely, brokerage commissions on mutual fund transactions to pay for the marketing and distribution of mutual funds in the MFS Fund Complex (MFS Funds). The Commission issued an order that found MFS failed to adequately disclose to the Boards of Trustees and to shareholders of the MFS Funds the specifics of its "shelf-space" arrangements with brokerage firms and the conflicts created by those arrangements. As part of the settlement, MFS agreed to a series of compliance reforms and to pay a penalty of $50 million, which will be distributed to the MFS Funds. In addition, as I previously stated, the Commission has proposed to ban the use of brokerage commissions to compensate broker-dealers for the distribution of fund shares.

Our third area of priority in the mutual fund examination and enforcement arena is the sale of different classes of mutual fund shares. Many mutual funds offer multiple classes of shares in a single portfolio. For each class of shares, a mutual fund uses a different method to calculate and collect distribution costs from investors. Class A fund shares are subject to an initial sales charge (front-end load); discounts on front-end loads are available for large purchases of Class A shares. Since the sales fee is paid up front, Class A shares incur lower (or no) "Rule 12b–1 fees," fees the mutual fund pays for distribution costs, including payments to the broker-dealers and their registered representatives selling fund shares.

Last July, the Commission brought an action against Prudential Securities for abuses in this area. In that case, the Commission found that Prudential's supervisory system for overseeing practices in this area was inadequate. Prudential had in place policies and procedures requiring registered representatives to advise their clients of the availability of different classes of mutual funds and fully explain the terms of each. Prudential branch managers were also expected to approve all purchases greater than $100,000 and confirm the suitability of the choice of fund class. The Commission found, however, that Prudential failed to adopt a sufficient supervisory system to enable those above the branch manager to determine whether these policies and procedures were being followed. In resolving the Commission's action, Prudential was censured and agreed to pay disgorgement and a civil penalty. The Commission's action against the registered representative and branch manager, which charges them with fraud, is pending.

The fourth examination and enforcement priority area with respect to mutual funds is to address the failure of firms to give their customers the discounts available on front-end loads for large purchases of Class A shares. Last year, examiners at the SEC, NASD, and NYSE completed an examination sweep and outlined the results in a public report. This sweep culminated in the filing, on February 12, 2004, of enforcement and disciplinary actions against a total of 15 firms for failure to deliver mutual fund breakpoint discounts during 2001 and 2002. The 15 firms agreed to compensate customers for the overcharges, pay fines in an amount equal to their projected overcharges that total over $21.5 million, and undertake other corrective measures. The NASD has ordered all firms to repay their customers any amounts overcharged.

While these are areas of focus in the mutual fund arena, the Examination staff, in coordination with the Enforcement staff, are continually on the look out for additional mutual fund practices that may be vulnerable to or ripe for abuse. Accordingly, the staff is closely examining, among other things, the status of funds closed to new investors that nevertheless continue to charge Rule 12b–1 fees, the portfolio pricing practices of high yield bond funds, the role of pension consultants in pension plans' selection of particular money managers, the use of "fair value" pricing, the use of affiliated service providers, and the fees charged by certain index funds. And in all of the foregoing areas, the Commission is intently focused on the roles and conduct of mutual fund directors. Have they adequately discharged their responsibilities? Have they properly overseen the mutual fund management company on behalf of mutual fund shareholders?

Internal Restructuring

The third key element in enhancing the protection of our Nation's mutual fund investors—indeed of enhancing the protection of all of our Nation's investors—is the internal restructuring of the Commission's management and functions. One of my primary goals since coming to the Commission has been to help restore the Commission's credibility as the investors' watchdog. This, of course, means reforming how the Commission operates. I will briefly summarize these reforms for you.

Last year, following a thorough internal review of how the Agency deals with risk, we initiated a new risk management program and laid the groundwork for the Office of Risk Assessment and Strategic Planning, the first of its kind at the Commission. The first phase has been to organize internal risk teams for each major program area. This framework has already been put into place and allows for a bottom up approach to assessing risk. A good example of this is through our Office of Compliance Inspections and Examinations. We have empowered our examiners, through OCIE's internal risk management team, to look at potential problems in the mutual fund and broker dealer industries and to examine formally for these potential problem areas.

The new Office of Risk Assessment will work in coordination with the internal risk teams and will push the Agency to identify proactively potential problem areas within the mutual fund and broker-dealer industries, focusing on early identification of new or resurgent forms of fraudulent, illegal, or questionable activities. In addition to fostering better communication and coordination between Divisions and Offices within the Commission, the risk assessment initiative will help to ensure a process whereby senior managers at the Commission have the information necessary to make better, more informed decisions and to adjust operations and resources to address these new challenges.

We also have greatly enhanced our examination program, as our Director of the Office of Compliance Inspections and Examinations, Lori Richards, shared with you a few weeks ago. In 2003, budget increases allowed us to increase our staff for fund examinations by a third, to approximately 500 staff. These new resources, coupled with the Office's new risk-based examinations approach, should greatly improve our ability to detect abusive behavior and possible violations of the law.

In addition to the overarching risk assessment effort has been the creation of a number of multidivisional task forces designed to bring together staff from various divisions and offices to brainstorm, evaluate and create strategies to proactively undertake issues of potential concern in protecting the Nation's securities markets.

Four of these task forces will tackle issues that will help us better protect mutual fund investors and monitor the mutual fund industry. They are the Chairman's Task Forces on: Soft-Dollar Arrangements; College Savings Plans (or 529 plans); Enhanced Mutual Fund Surveillance; and Disclosure Regime. The Task Forces will meet with the relevant interested parties—such as individual investors, industry representatives, fellow regulators, and others—to gather critical intelligence and data, and ultimately work toward addressing problem areas.

Let me start with the Task Force on Soft Dollars, because I know this issue is of particular concern to some of you on the Committee, and I want to assure you that it is also a very high priority for the Commission in the context of our mutual fund reforms.

The Task Force on Soft Dollars, comprised of SEC staff from five divisions and offices, has already met with a number of industry representatives as it tackles this complicated issue. Its goal is to fully understand all aspects of how soft dollars are used, and the pros and cons of various alternative reform approaches, including possible unintended consequences. While I would like to have those recommendations as soon as possible, I also want to ensure that the Task Force has adequate time to fully consider the issue and the benefit of meeting with interested persons so that it can come to us with the best and most informed recommendations possible.

Like so many of the issues we are facing, the area of soft dollars is complex, and we must be cautious as we move forward with reforms in this area. I believe that at the very least, the Commission, through the rulemaking process, should consider narrowing the definition of qualifying "research" under the safe harbor so that only "real" research that has valid, intellectual content, qualifies. I would also expect the Task Force to consider whether the costs of research and execution should be quantified and other ways in which the costs of research could be made more transparent. Some have advocated a distinction between third-party research and proprietary research. My view is that we should not draw such distinctions, but the Task Force will also consider this issue and provide recommendations. As you are aware, the Securities Exchange Act contains a statutory safe harbor, Section 28(e) of the Exchange Act, which protects use of soft dollars. So, the Task Force will also consider whether Section 28(e) of the Exchange Act should be repealed. While I have not yet reached that conclusion, if the Task Force and the Commission ultimately arrive at that conclusion, I will not hesitate to seek Congress' assistance in that endeavor.

Because there are growing concerns with disclosure and transparency with respect to 529 tuition savings plans, or college savings plans, we have established a task force on college savings plans. This task force is charged with examining the issue of college savings plans, including a focus on the structure and sale of college savings plans and disclosures to plan participants, particularly with respect to fees and expenses. More specifically, I have asked the Task Force to review disclosure and transparency for investors in these plans, the extent of the Commission's oversight of these plans and whether the costs and fees associated with these plans outweigh the tax advantages of these plans for families saving for their children's educations.

Another critical area where the Commission will be more proactive is mutual fund surveillance. In this vein, we have formed a Task Force on Self-Reporting Regimes for Mutual Funds to look at both the frequency of reports made by mutual funds to the Commission and the categories of information to be reported. Further, this Task Force will examine how new technologies can best be used to enhance our oversight responsibilities. The Task Force will draw on the expertise of our fellow regulators at the NYSE, NASD, and NASAA, as well as others knowledgeable in the area of surveillance and reporting.

Another critical area for Commission review is our disclosure regime. Because the Federal securities laws are largely disclosure based, investors receive a large volume of disclosure documents, especially when they invest in a mutual fund. The Task Force on Disclosure will examine the value of the various disclosures provided by mutual funds, brokers and issuers to investors as required by our rules and regulations. The Task Force will also explore what types of disclosures best serve investors, the timing of the disclosures, delivery versus access to the disclosures, and how best to harness technological advances in assisting investors. In addition, the Task Force will analyze whether there is data that the Commission should collect and publish on a periodic basis that would be useful to investors in making comparisons among the various investment options available to them. This Task Force will reach out to investors to help guide it through the important task of ensuring that investors are receiving the proper mix of disclosure in a format meaningful to them.

Hedge Funds

Before closing, I would note that hedge funds have played significant roles in some of the most notorious mutual fund scandals that have come to light recently—the Bank of America/Canary Hedge Fund case is one example. So, I would like to summarize my personal concerns related to hedge funds, with the caveat that my views on hedge funds are my own and do not reflect the views of the entire Commission.

The issues surrounding hedge funds are an excellent example of how the Commission can be proactive and work to enhance enforcement in problem areas before they spread. The Commission is responsible for enforcing the Federal securities laws, policing the securities markets, and ensuring fraud prevention and detection. This is the Commission's responsibility regardless of whether we are talking about mutual funds, self regulatory organizations, public companies, hedge funds, or other market participants. Hedge funds have become one of the fastest growing segments of the investment management business—with assets fast approaching $1 trillion—at a time when returns on other investments have not kept the same pace.

Other Government entities—primarily the Federal Reserve Board and the Treasury—are responsible for monitoring potential systemic risks, and the safety and soundness issues raised by the structure of these vehicles. While their oversight priorities are of great import to our banking system, these agencies are not responsible

for enforcing the Federal securities laws and protecting investors. The data they collect is aimed at the discharge of their prudential responsibilities. Any regulatory action the Commission ultimately takes will focus on the protection of investors, rather than safety and soundness issues.

I would also like to address the need for protecting investors in the hedge fund context. One of the points I often hear about not regulating hedge funds is that hedge fund investors are wealthy and sophisticated individuals who do not need protecting. This is not the point. Hedge fund managers are, directly and indirectly, providing advisory services for many U.S. investors—with a significant impact not only on those investors, but also on the operation of the U.S. securities markets. The Commission is the only Government agency that is charged with protecting those investors and policing those markets. Further, hedge funds are being purchased by intermediaries on behalf of millions of ultimate smaller investor beneficiaries—retirees, pensioners, and others not generally thought of as the traditional hedge fund investor—through their pension plans or funds of hedge funds, again making it critical for investors that the Commission have basic information and a resulting insight as to how many hedge fund managers are deploying assets under management; how they handle conflicts of interest, how they account for results and value their investments, and most importantly, what impact their market activities have on the other participants in our equity markets.

Moreover, hedge funds often promise performance in all types of market conditions, and typically include hefty performance fees for their managers. This combination can motivate unscrupulous hedge fund managers to attempt behavior or conduct that circumvents or crosses the legal boundaries of the securities laws.

As we move forward to debate this issue, there are a few questions that I think we need to consider: How are hedge fund managers pricing the securities in their portfolios? What practices are in place regarding hedge funds' use of and access to inside information? How do hedge fund managers conduct their securities trading? What prevents hedge funds from front-running mutual funds or other large investors? What are hedge funds' activities regarding initial public offerings? How hedge funds answer these questions not only has an impact on the investors in the hedge funds, but also more importantly has a significant impact on all investors in our markets, including those investors that have exposure to hedge funds indirectly, whether through their retirement and pension plans or through funds of hedge funds.

It troubles me that the Commission, under the current rules, is limited in its ability to gather information that could provide answers to these questions, and could help protect millions of investors. I fundamentally believe that the Commission has a legitimate interest in obtaining the information, and imposing appropriate recordkeeping and other regulatory requirements, if needed, to protect investors receiving advisory services from hedge fund managers. Further, what we have found in the mutual fund scandals supports this concern. We have seen hedge fund managers engaged in illegal behavior that results in taking advantage of the long-term retail investors in these funds. Critics cannot have it both ways—on the one hand, to demand that the Commission be proactive and prevent and detect emerging, but as of yet unforeseen, harms and abuses, but on the other hand, to handicap our ability to obtain information that facilitates our identification of such abuses.

Let me be clear: I believe hedge funds play a vital role in our financial markets, and I would reject any regulatory proposal that would in any way impede the ability of hedge funds to function as they currently do, so long as we have the ability to ensure that their managers are not taking advantage of millions of investors. This is a point the Commission staff made clear in its report on hedge funds last fall.

Mindful of the balance between fulfilling our responsibility to protect investors and protecting hedge funds' vital role in our financial markets, I have asked the staff to move forward with a rulemaking proposal that would enhance the Commission's ability to prevent, detect and deter abusive, fraudulent conduct in the hedge fund segment of the investment management industry. As part of this rulemaking, and building on the risk assessment capability we are developing in the Agency—including our new risk identification and mapping programs, we could consider both a form of registration for hedge fund managers and an oversight regime different from that which we use for other, more heavily regulated industries, like mutual funds. They could be specifically tailored to the unique dynamics of these types of managers. We could thus better target our inquiries on those hedge fund managers where there is some reasonable concern that they may be violating the securities laws.

As with all rulemaking proposals, this one will have to be voted upon by the Commission and would go through the notice and comment process so as to consider the views of all interested persons on this subject. I intend to ensure that the Commis-

sion's consideration of the hedge fund issue is thoughtful and thorough, and that any proposal will be fully and appropriately vetted.

Conclusion

As my testimony—taken together with previous testimony from the Commission staff—demonstrates, the Commission has embarked on an aggressive regulatory and enforcement agenda to combat the current ills plaguing the mutual fund industry. I believe our efforts will help ensure that there are strong safeguards in place to minimize the possibility of future illegal, fraudulent, or harmful activity. We have ample regulatory authority with which to carry out this agenda, and—due in large part to your support and your constructive approach—we have been able to pursue this agenda in an expedited manner.

Please allow me to once again complement the Committee, Mr. Chairman, for its thoughtful and thorough approach to the oversight of these issues. The significant number of hours that you and the staff have spent conducting oversight hearings, and questioning witnesses from all segments of the industry, has been immensely helpful to the Commission, and represents a constructive approach to analyzing the complexity of the problems that have plagued the mutual fund industry. The Commission—and indeed the mutual fund investor—has benefited from your approach and your efforts, and I thank you.

If, as the Commission moves ahead with its mutual fund reforms, there are critical issues that we do not have the ability to address, the Commission will immediately seek your assistance to do so; however, I do not believe that legislation is necessary at this time.

Thank you again for inviting me to speak on behalf of the Commission to discuss our efforts to protect the investing public. I would be happy to answer any questions that you may have.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR REED FROM WILLIAM H. DONALDSON

Q.1. Does the SEC have a standard format in which electronic evidence from mutual fund operators is collected and reviewed? Is there a need for such a standard?

A.1. Electronic data, such as electronic mail, is an important component of many enforcement investigations, including those involving mutual funds. To facilitate efficient review of two common forms of electronic data, the Division of Enforcement has established "preferred formats" for the production of electronic mail and imaged documents. Parties producing electronic mail or imaged documents are requested, but not required, to utilize these preferred formats. These two categories of electronic data account for the large majority of electronic productions made to the Enforcement staff. In addition, under Exchange Act Rule 17a–25, when the Commission requests transaction data from a registered broker-dealer, the firm must submit the information electronically in an industry standard format known as the Electronic Blue Sheet format. "Blue Sheeting" is the primary means of transmitting trading data to the SEC and self-regulatory organizations.

The Enforcement Division does not require production of electronic data in a particular format in order to accommodate parties producing the data and, where feasible, limit the associated burden. In addition, because conversion of electronic data to a format other than the one in which it is maintained may cause a loss of information, it is often beneficial to accept production of electronic data in its native format. This is one of the reasons that the Enforcement Division uses *preferred* formats rather than *required* formats. In the staff's view, because maintaining flexibility concerning the format in which electronic data is produced can yield more complete information, a mandatory format for production of electronic data is unnecessary.

Q.2. In his testimony before this Committee on February 25, Gary Gensler argued that Congress should amend or repeal the Gartenberg Standard. This legal standard essentially says that to be found excessive, an adviser's fee must be so large that it has no relationship to the services rendered and could not have come from 'arm's-length' bargaining. Do you believe that Congress needs to pass legislation that would statutorily create a new, stronger standard for reasonableness of adviser fees?

A.2. Section 36(b) of the Investment Company Act of 1940 imposes on fund investment advisers a fiduciary duty with respect to their receipt of compensation from funds.[1] Congress adopted Section 36(b) in response to concerns that fund advisory fees were not subject to the usual competitive pressures because funds typically are organized and operated by their investment advisers.[2] As inter-

[1] Section 36(b) specifically authorizes the Commission, and any fund shareholder, to bring an action in Federal district court against the fund's investment adviser for a breach of fiduciary duty "with respect to the receipt of compensation for services, or of payments of a material nature" made by the fund to the investment adviser (or to an affiliated person of the investment adviser).

[2] *See* SEC, REPORT ON THE PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH, H.R. REP. NO. 2337, 89th Cong., 2d Sess. 10–12, 126–27, 130–32 (1966). *See also,* DIVISION OF

preted by the courts, directors' responsibilities under Section 36(b) involve the evaluation of whether the compensation that is paid to a fund's investment adviser is "so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's length bargaining," otherwise known as the *Gartenberg* standard—a reference to one of the leading court cases interpreting section 36(b).[3] Based on the *Gartenberg* standard, when approving and renewing investment advisory agreements, particularly the compensation to be paid to the investment advisers, fund directors typically consider the following relevant factors:

- The nature and quality of all of the services provided by the adviser (either directly or through affiliates), including the performance of the fund;
- The adviser's cost in providing the services and the profitability of the fund to the adviser;
- The extent to which the adviser realizes economies of scale as the fund grows larger;
- The "fall-out" benefits that accrue to the adviser and its affiliates as a result of the adviser's relationship with the fund (*for example,* soft-dollar benefits);
- The performance and expenses of comparable funds; and
- The volume of transaction orders that must be processed by the adviser.

While the *Gartenberg* standard establishes a test for when advisory fees become excessive, the court cases provide that the decisions of independent directors regarding advisory fees will not be second-guessed if the directors are fully informed[4] and considered all appropriate factors in determining the reasonableness of fees.[5] I agree that the amount of mutual fund fees generally should not be set by courts or by the Commission. Fees should be determined by the marketplace, and investor consideration of mutual fund costs can be facilitated by transparent disclosure of fund fees and expenses and the effective and diligent oversight of independent fund directors. That is why the Commission is focused on improving fund disclosure—particularly disclosure about fund fees, con-

INVESTMENT MANAGEMENT, PROTECTING INVESTORS: A HALF CENTURY OF INVESTMENT COMPANY REGULATION 317–19 (May 1992).

[3] *Gartenberg* v. *Merrill Lynch Asset Management, Inc.* 694 F.2d 923, 928 (2d Cir. 1982). *See also, Gartenberg* v. *Merrill Lynch Asset Management, Inc.,* 740 F.2d 190 (2d Cir. 1984).

[4] Like fund directors, fund investment advisers are subject to fiduciary duties under State and Federal law in connection with the approval and renewal of investment advisory contracts. *See, e.g. Transamerica Mortgage Advisors, Inc.* v. *Lewis,* 444 U.S. 11, 17 (1979). Fund investment advisers are subject to duties of care and loyalty and must affirmatively disclose to a fund's board of directors all facts that are material to the board's approval and renewal of the investment advisory contract. *See, e.g., SEC* v. *Capital Gains Research Bureau, Inc.,* 375 U.S. 180, 191–92 (1963); In the Matter of Kemper Financial Services, Inc. *et al.,* Investment Advisers Act Release No. 1476 (March 2, 1995); In the Matter of Joan Conan, Investment Advisers Act Release No. 1446 (September 30, 1994). In particular, a fund's investment adviser is required by the Investment Company Act to furnish "such information as may reasonably be necessary" for the fund's directors to evaluate the fund's investment advisory contract. *See* Section 15(c) of the Investment Company Act of 1940.

[5] *See, e.g., Schuyt* v. *Rowe Price Prime Reserve Fund, Inc.,* 663 F.Supp. 962, 971 (S.D. N.Y. 1987) *aff'd.,* 835 F.2d 45 (2d Cir. 1987). "The legislative history of the [Investment Company] Act clearly indicates that it is not the role of the Court to 'substitute its business judgment for that of the mutual fund's board of directors in the area of management fees.'" *Id.* (quoting S. Rep. No. 194, 91st Cong., 1st Sess., reprinted in 1970 U.S. Code Cong. & Ad. News 4902).

flicts, and sales incentives—and enhancing the mutual fund governance structure.

The Commission has taken several recent steps to significantly improve the information required for individual shareholders. For example, the Commission adopted a requirement that shareholder reports include dollar-based expense information so that investors can easily compute the dollar amount of expenses paid on their investment in a fund.[6] This is an important step in providing shareholders with critical information about their mutual fund investments. In other efforts to improve disclosure for investors, the Commission has:

- issued a concept release on methods to calculate and improve the disclosure of funds' portfolio transaction costs; [7]
- proposed to make more transparent in shareholder reports how fund boards evaluate investment advisory contracts; [8]
- proposed new fund confirmation forms and new point-of-sale disclosure that would greatly enhance the information that broker-dealers provide their customers in connection with mutual fund transactions, and highlight the conflicts that broker-dealers face in recommending mutual fund investments; [9] and
- proposed improved prospectus disclosure to address the wide-scale failure on the part of broker-dealers to provide appropriate breakpoint discounts on front-end load mutual fund purchases.[10]

With respect to fund governance, the Commission recently proposed a comprehensive rulemaking package to bolster the effectiveness of independent directors and enhance the role of the fund board as the primary advocate for fund shareholders. The proposals included a requirement for (i) an independent board chairman; (ii) 75 percent independent directors; (iii) independent director authority to hire, evaluate, and fire staff; (iv) quarterly executive sessions of independent directors outside the presence of management; (v) an annual board self-evaluation; and (vi) preservation of documents used by boards in the contract review process.[11] This significant overhaul of the composition and workings of fund boards is intended to establish, without ambiguity, the dominant role of independent directors on a fund's board.

As a result of the Commission's initiatives to improve fund disclosure and fund governance, I do not believe that it is necessary at this time for Congress to revise the statutory standards regarding fund fees. I believe that the best way to ensure that funds

[6] *See* Shareholder Reports And Quarterly Portfolio Disclosure of Registered Management Investment Companies, Investment Company Act Release 26372 (February 27, 2004) [69 FR 11244 (March 9, 2004)].

[7] *See* Request for Comments on Measures to Improve Disclosure of Mutual Fund Transaction Costs, Investment Company Act Release 26313 (December 18, 2003) [68 FR 74820 (December 24, 2003)].

[8] *See* Disclosure Regarding Approval of Investment Advisory Contracts by Directors of Investment Companies, Investment Company Act Release 26350 (February 11, 2004) [69 FR 7852 (February 19, 2004)].

[9] *See* Confirmation Requirements and Point-of-Sale Disclosure Requirements for Transactions in Certain Mutual Funds and Other Securities, and Other Confirmation Requirement Amendments, and Amendments to the Registration Form for Mutual Funds, Investment Company Act Release 26341 (January 29, 2004) [69 FR 6438 (February 10, 2004)].

[10] *See* Disclosure of Breakpoint Discounts by Mutual Funds, Investment Company Act Release 26298 (December 17, 2003) [68 FR 74732 (December 24, 2003)].

[11] *See* Investment Company Governance, Investment Company Act Release 26323 (January 15, 2004) [69 FR 3472 (January 23, 2004)].

charge fair and reasonable fees is through a marketplace of vigorous, independent, and diligent mutual fund boards, coupled with fully informed investors who are armed with complete, easy-to-digest disclosure about the fees paid and the services rendered.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR CORZINE FROM WILLIAM H. DONALDSON

Q.1. The last time you appeared before this Committee, Senator Miller submitted questions to you on the National Securities Clearing Corporation's (NSCC) proposed rule. And then subsequent to that he submitted a comment letter on December 22, 2003, on the proposed rule. We understand the rule is still pending before the SEC. In Senator Miller's questions and letter he expressed reservations about a rule that would allow the NSCC to open up shop in an entirely new industry (Separately Managed Accounts) from what its been doing since its creation. As he said in his letter, we question a rule that would allow a quasi-government SRO to take business away from private companies that have invested millions to work out their SMA business and eventually make a profit in it, especially when, if this rule is approved, the NSCC would carry a kind of SEC "stamp of approval" that will inevitably give them a competitive advantage over the private companies.

We have since learned that SEC procedures would allow this rule to go into effect without a single Commissioner ever having reviewed, much less voted, on it. We find that very troubling, Mr. Chairman, on a matter as important as this one is, and we would like your assurance today that you and your colleagues on the Commission will personally review any decision/recommendations the Commission staff puts forward on the NSCC rule.

A.1. NSCC is a subsidiary of Depository Trust and Clearing Corporation (DTCC), which is owned by its bank and broker-dealer members. NSCC provides coordinated comparison and clearance services to the financial markets. It currently is the sole clearance system for equities, as a result of consolidation of many competitors that has taken place over the past two decades. NSCC has developed many new services upon request of its members, in order to reduce processing costs by providing standardized interchanges of information inexpensively, on a widely available basis. Some of these new services involve regulated clearing agency activities; others do not. Where possible, NSCC has engaged in these activities internally rather than through an affiliate, to use existing systems to reduce costs. The SMA Service is only one of such services offered by NSCC.

The SMA Service is an information messaging system for separately managed accounts, which is similar to the information messaging system NSCC currently provides for mutual funds in its Mutual Fund Profile Service. The Mutual Fund Profile Service automates the flow of information between users through a centralized system using standardized formats. It allows users to, among other things, exchange accurate and timely information of daily prices and dividend rates, firm and fund member profiles, individual security data, and projected and actual distribution declarations.

NSCC is a private, member-owned entity that is organized as a not-for-profit corporation under the laws of the State of New York. It is registered with the Commission as a clearing agency (pursuant to Sections 17A and 19 of the Securities and Exchange Act of 1934) and as such is a self-regulatory organization subject to extensive Commission oversight. It was not created by any U.S. governmental action.

As a registered clearing agency, NSCC is required under Section 19(b) of the 1934 Act to file any proposed rule change, which includes the offering of new service, with the Commission. Commission approval of a proposed rule change means only that the Commission has found that the proposed rule change is consistent with the requirements of the 1934 Act and rules and regulations thereunder applicable to the clearing agency. It is not a determination as to the relative market value of any service proposed to be offered by the clearing agency nor is it an endorsement of the service. If users of a service value the fact that the service is offered by a registered clearing agency, it is most likely because the clearing agency is subject to extensive Commission oversight and review and not because the Commission has given a stamp of approval to the service.

With regard to the Commission's review of the proposed rule change, the Commission has authority pursuant to Section 4A of the 1934 Act to delegate any of its functions to a division of the Commission. Section 200.30–3(a)(12) of the Commission's regulations delegates to the Director of the Division of Market Regulation the authority to approve proposed rule changes filed by self-regulatory organizations. However, because of the interest expressed by you, and by other Members of Congress, and because of the comments the Commission has received regarding the proposed rule change, I can assure you that I and the other Commissioners will be kept apprised of any recommendations made by Division staff regarding the proposed rule change.

Q.2. We understand that the rule is silent on the fees that will be charged when and if this rule is approved. As Senator Miller said in his letter, we are curious about where the funding is coming from to subsidize the high priced legal and lobbying talent, among other expenses, that the NSCC has expended in the course of this effort. Apparently, the NSCC's own comment letter sought to answer my question, and said that the money to fund this effort is coming from "the general funds" of the Corporation (p.29), as though that is some other source other than mutual fund-related fees. In your response to us, we would like to know, precisely, what the source for the NSCC's funding for this effort is, and whether any of it comes, directly or even indirectly, from mutual fund fees?

A.2. Regarding further clarification for the funding of the SMA Service and whether any of the money used to fund the service is coming from fees NSCC collects for its mutual fund services, NSCC has funded the start-up costs for the SMA Service out of its general corporate funds as it generally does with new services. NSCC's general funds are comprised of revenues NSCC receives from all its services, including mutual fund services. NSCC retains only the revenues that are required in order to maintain an adequate rev-

enue base for current operation costs, product and service enhancements and developments, and earnings as directed by the board. In accordance with this policy, NSCC's Board, comprised of representatives of its owner-users, determines when to reserve revenues as general corporate funds and which new product development efforts shall be funded from reserved revenues. To the extent that revenues in excess of NSCC's costs to provide its services are not so reserved, the Board has followed the practice of refunding these excess revenues to its members in proportion to the fees paid by them. Mutual fund revenues represent less than 25 percent of NSCC's total revenues.

It is important to note that NSCC designs its services to be self-supporting and so there is an expectation that any start-up costs of the SMA Service will be paid back to the general fund from SMA Service fees. As a result, the fees NSCC will charge for the SMA Service will initially be higher than they would be if the SMA Service were an existing service of NSCC. Additionally, the start-up costs for the SMA Service are not very high. NSCC will use its existing connectivity for the service and has only had to incur costs for the systems development of the service.

With regard to NSCC funding its lobbying and legal expenses related to the SMA Service, NSCC has informed the Commission that it has not invested a significant amount of money in lobbying or legal expenses. It has not lobbied for the SMA Service, and it has hired legal counsel only to respond to questions from Congress and to the comments submitted to the Commission as part of the public process on the rule filing.

RESOPONSE TO WRITTEN QUESTIONS OF SENATOR ENZI FROM WILLIAM H. DONALDSON

Q.1. In response to questions asked by Senator Sarbanes, you stated that the SEC was having difficulty hiring accountants. How many SEC staff have been hired away by the PCAOB? In addition, how has the PCAOB's ability to compensate staff more than the SEC hurt the SEC's ability to recruit accountants and staff?

A.1. The PCAOB has hired approximately 7 SEC staff since its inception. Most of these employees were instrumental in starting the Board and ensuring that it was able to meet the statutory commencement deadlines of the Sarbanes-Oxley Act.

Hiring accountants with the experience and skills we need continues to be a challenge. This is because there is high demand for seasoned accountants in the private sector—not just from the PCAOB. While we did lose some staff to the PCAOB early on, we do not believe the salary differences between us and the PCAOB have proven to be a significant factor in our hiring difficulties. This is primarily because we have not been seeking the same types of accountants as the PCAOB. We have been seeking journeymen level accountants with at least 5 years of experience to review SEC filings and more senior accountants with experience in dealing with complex accounting issues to fill positions in the Division of Enforcement and the Office of the Chief Accountant; whereas we understand that the PCAOB is seeking very senior accountants with 10 or more years of auditing experience. This difference means that we are drawing from different pools of available candidates.

We currently hope to complete hiring for all of the accountant positions we have received by the end of this year.

Q.2. The intent of Congress in enacting the Investment Company Amendments Act of 1970 was to relieve independent directors of personal liability other than for "personal misconduct." Do you think Congress should change this concept and impose a personal liability on independent directors for violations by the investment adviser?

A.2. Section 36(a) of the Investment Company Act, as amended in 1970, states

> The Commission is authorized to bring an action in the proper district court of the United States, or in the United States court of any territory or other place subject to the jurisdiction of the United States, alleging that a person serving or acting in one or more of the following capacities has engaged within 5 years of the commencement of the action or is about to engage in any act or practice constituting a breach of fiduciary duty involving personal misconduct in respect of any registered investment company for which such person so serves or acts—
>
> 1. as officer, director, member of any advisory board, investment adviser, or depositor; or
>
> 2. as principal underwriter, if such registered company is an open-end company, unit investment trust, or face-amount certificate company.
>
> If such allegations are established, the court may enjoin such persons from acting in any or all such capacities either permanently or temporarily and award such injunctive or other relief against such person as may be reasonable and appropriate in the circumstances, having due regard to the protection of investors and to the effectuation of the policies declared in Section I (b) of this title.

Section 36(a) permits the Commission to bring an action against a director for a breach of fiduciary duty involving "personal misconduct," which generally is a higher standard than required for a civil action under State law. However, as originally enacted, the Investment Company Act only permitted the Commission to sue directors whose breaches involved "gross misconduct." Thus, the 1970 Amendments to the Investment Company Act expanded the Commission's ability to bring cases against directors. The term "personal misconduct" is not defined in the statute or explained in the legislative history.

Mutual fund directors' fiduciary duties arise primarily from the law of the state in which they are organized. Fund directors are subject to fiduciary duties of care and loyalty. The duty of care generally requires that directors act with that degree of diligence, care, and skill that a person of ordinary prudence would exercise under similar circumstances in a like position.[1] The duty of loyalty generally requires fund directors to exercise their powers in the interests of the fund and not in the directors' own interests or in the interests of another person or organization (*for example,* the invest-

[1] *See, e.g., Hanson Trust PLC* v. *ML SCM Acquisition Inc.,* 781 F.2d 264, 273 (2d Cir. 1986) and *Norlin Corp* v. *Rooney, Pace Inc.,* 744 F.2d 255, 264 (2d Cir. 1984).

ment adviser).[2] Under State law, the business judgment rule can protect fund directors from liability for their decisions, so long as the directors acted in good faith, were reasonably informed, and rationally believed that the action taken was in the best interests of the fund.[3]

In addition to these fiduciary duty standards, the Investment Company Act imposes direct obligations on fund directors. For example, the Act requires fund directors to assign fair valuations as determined in good faith to certain portfolio securities,[4] to request and evaluate such information as may reasonably be necessary to evaluate the fund's advisory contract;[5] and to select a fund's independent auditor.[6] The Commission could sue fund directors if they fail to appropriately perform these assigned duties, regardless of whether the violation involved "personal misconduct."[7] Additionally, as raised in your question, the Commission has authority to sue fund directors for aiding and abetting a violation by the fund's adviser.[8] The Commission also can obtain a cease and desist order against fund directors if they are, were, or would be a "cause" of a violation under the Investment Company or Investment Advisers Acts, or their rules, due to an act or omission a director knew or should have known would contribute to such violation.[9] I do not believe, however, that it would be appropriate to impose a direct personal liability on independent directors for violations by the investment adviser.

Q.3. In your testimony today, you stated that you are requesting the staff to move ahead with a proposal to oversee the hedge fund industry. To date, the SEC has not finalized Phase 2 of the Investment Advisor Registration Depository. In addition, the SEC has not fully hired all of the staff necessary to oversee the mutual fund industry. Based upon your testimony, it appears that the SEC would have to expend significant monies to make changes to the registration depositories for hedge funds and to hire the appropriate staff to oversee and examine hedge funds.

How can the SEC move forward on hedge funds when it has not finished its job in those areas and exactly how much money will the SEC need to regulate hedge funds?

A.3. Portions of the IARD system necessary to register hedge fund advisers have been fully operational since 2001. Part 2 of the system, which is currently under development, will add additional system functionality that will permit investment adviser disclosure statements to be filed.

The SEC has moved forward with hiring additional examiners to oversee mutual funds and investment advisers, and we are tar-

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[2] *See* the policy directives contained in Sections 1(b)(2), (4), and (6) of the Investment Company Act of 1940 Act. *See also, Norlin Corp* v. *Rooney, Pace Inc.,* 744 F.2d 255, 264 (2d Cir. 1984), citing *Pepper* v. *Litton,* 308 U.S. 295, 306–07 (1939).

[3] *See, e.g., Salomon* v. *Armstrong,* 1999 Del. Ch. LEXIS 62, 23 (Del. Ch. March 25, 1999). *See generally* Dennis J. Block *et al.,* THE BUSINESS JUDGMENT RULE—FIDUCIARY DUTIES OF CORPORATE DIRECTORS (5th ed. 1998).

[4] *See* Section 2(a)(41) of the Investment Company Act of 1940.

[5] *See* Section 15(c) of the Investment Company Act of 1940.

[6] *See* Section 32(a) of the Investment Company Act of 1940.

[7] See Section 9(b)(2) of the Investment Company Act of 1940.

[8] *See* Section 9(b)(3) of the Investment Company Act of 1940.

[9] *See* Section 9(f) of the Investment Company Act of 1940; Section 203(k) of the Investment Advisers Act of 1940.

geting more examinations of funds and advisers posing the greatest compliance risks. Hedge fund advisers face several conflicts of interest that raise compliance risks, including side-by-side management and soft dollars, and our ability to examine these firms is critical if we are to detect and deter frauds. We now have 495 staff allocated to examining funds and advisers nearly a 30 percent increase from fiscal 2002. We are focused on hiring the best, most appropriate people to meet staffing needs, and have refused to hire employees simply to fill chairs. By the end of the year, we fully expect that we will achieve current targeted staffing levels. As a preliminary matter, our staff has estimated the pool of SEC-registered advisers would increase by approximately 10 percent if we impose our current adviser registration requirements on hedge fund managers, though the number could be higher. Our 2005 budget request incorporates $18.7 million for additional staffing positions necessary to implement recent Commission initiatives as well as possible regulation in the hedge fund adviser area.

Q.4. Recently, the SEC proposed a set of minimum standards for market linkages in its NMS rule proposal. With respect to the proposed rule to establish a hard 4 p.m. close, is one of the alternatives that the SEC is considering the establishment of minimum standards for electronic timestamping to allow the market to establish the best way to accurately timestamp mutual funds orders? If not, what are the obstacles to establishing minimum standards.

A.4. The Commission is considering a number of alternatives to the amendments it proposed last fall to respond to late trading in mutual fund shares. As you know, that proposal would permit a purchase or redemption order for mutual fund shares to be priced as of the day it is received, if the fund, its designated transfer agent, or a registered clearing agency receives the order by the fund's designated pricing time (typically 4 p.m. eastern time). The Commission received more than 1,000 comment letters on the proposal. Many commenters recommended that the rule provide an exception for fund intermediaries, such as retirement plan administrators and fund service providers, that implement certain controls such as an unalterable, automatic timestamp on each order received. Other commenters have suggested the Commission require an order to purchase or redeem fund shares be submitted to a central clearinghouse by the fund's pricing time in order to receive same-day pricing. The Commission and its staff are meeting with representatives of broker-dealers, retirement plan sponsors and administrators, fund companies, and fund service providers about the alternatives that they recommended, and they have explained their approaches in more detail, including requirements for a timestamp. We are considering these and other comments in order to substantially eliminate the potential for late trading while minimizing the costs of the regulations on funds and their investors.

Q.5. Mr. Chairman, your establishment of the Office Risk Assessment and Strategic Planning and the four task forces are a very good move forward for the Commission to be proactive on many issues rather than being reactive. I am particularly interested in how the Task Force on Disclosure Regime would operate. Often it seems that the investors are overwhelmed with the many disclo-

sures they receive and I am afraid many of the disclosures end up in the trash can. What is the timetable for the Task Force and how comprehensive will it be? For example, will it also cover disclosures required by the self-regulatory organizations?

A.5. The Commission has a long-term mission of improving the quality of disclosure to investors and other market participants, including financial intermediaries. The Commission seeks to ensure that its disclosure regime will be an effective one, and has charged the disclosure task force with evaluating that regime and recommending improvements.

To be effective, a disclosure regime must contemplate the manner in which information is communicated to the users of the information and the impact of the disclosure obligation on the provider of the information. The Task Force on Disclosure will therefore examine the value of the various disclosures provided by mutual funds, brokers, and issuers to investors as required by our rules and regulations. It will also explore what types of disclosures best serve investors, the timing of the disclosures, delivery versus access to disclosures, and how best to harness technological advances in assisting investors. In addition, the Task Force will analyze whether there is data that the Commission should collect and publish on a periodic basis that would be useful to investors in making comparisons among the various investment options available to them. The Task Force will report periodically to the Commission and will provide recommended courses of action.

RESONSE TO A WRITTEN QUESTION OF SENATOR MILLER FROM WILLIAM H. DONALDSON

Q.1. On February 5, 2004, *The Wall Street Journal* reported that the SEC is planning a formal review of the role of SRO's in the marketplace. The article was focused on the New York Stock Exchange, but we wonder if any final consideration of the NSCC's proposal, to compete with private sector companies already active in the Separately Managed Account (SMA) arena, should at least wait until your "concept release" exploring the relative benefits and drawbacks of various SRO models, including, we would hope, the NSCC example, as well as any public comments that might ensue. Do you agree?

A.1. SRO issues the Commission will consider first likely will primarily relate to the recent problems of transparency and self-policing in the securities markets, which would not have a significant impact on the structure or operations of clearing agencies.

Pursuant to Section 19 of the 1934 Act, the Commission is not empowered to put final consideration of a proposed rule change on hold. Under Section 19(b)(2), once a proposed rule change has been published for notice and comment the Commission is required either to approve a proposed rule change if it finds that such proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder or to disapprove the proposed rule change if it cannot make such a finding unless the SRO extends the time period. The Commission's action regarding SRO's does not appear to give a clear basis for the Commission to put on hold the approval/disapproval process of an SRO proposed rule change.

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

THE CHAIRMAN

June 29, 2004

Senator Jon S. Corzine
United States Senate
502 Hart Senate Office Building
Washington, D.C. 20510

Dear Senator Corzine:

I am writing to follow up on a request you made during the Committee on Banking, Housing, and Urban Affairs' April 8th hearing entitled "Review of Current Investigations and Regulatory Actions Regarding the Mutual Fund Industry." During my testimony, I referred to the possibility of rulemaking to enhance the Commission's ability to prevent, detect, and deter abusive, fraudulent conduct in the hedge fund segment of the investment management industry. You asked me to provide to you a statement on the Commission's authority to engage in rulemaking in this area.

At my request, the Commission's General Counsel has prepared a brief memorandum outlining potential sources of authority on which the Commission may draw. A copy of this memorandum is attached.

As with other issues affecting the Commission's responsibilities, we welcome the opportunity to share our views on these matters. If you have any further questions on this matter, please do not hesitate to contact me or Giovanni Prezioso, General Counsel, at (202) 942-0900.

Sincerely,

Bill Donaldson

William H. Donaldson

Attachment

MEMORANDUM

June 17, 2004

To: Chairman Donaldson

From: Giovanni Preziosio
General Counsel

Re: Commission's Authority to Regulate Hedge Fund Advisers

I. Background

During your April 8, 2004 testimony before the Senate Committee on Banking, Housing, and Urban Affairs, you referred to the possibility of rulemaking to enhance the Commission's ability to prevent, detect, and deter abusive, fraudulent conduct in the hedge fund segment of the investment management industry.[1] You indicated that the proposal could entail a form of registration for hedge fund advisers, tailored to the unique circumstances of these advisers. This memorandum discusses the sources of the Commission's authority to adopt rules related to the regulation of hedge fund advisers.

As you know, most hedge fund advisers are considered "investment advisers" for purposes of the Investment Advisers Act of 1940 (the "Act").[2] Section 203(a) of the Act generally requires investment advisers to register with the Commission.[3] Section 203(b)(3) of the Act, however, exempts from this registration requirement any investment adviser who, during the course of the preceding 12 months, has had fewer than 15 clients and who has not held himself out generally to the public as an investment adviser.[4] In 1985, the Commission adopted Rule 203(b)(3)-1, which includes a safe harbor allowing an adviser to count a corporation, general partnership, limited partnership, or other legal organization, as a single client.[5] The rule also provides that an investment adviser will not be deemed to be holding himself out solely because he participates in a non-public

1 At the hearing, Senator Corzine requested that you provide a statement on the Commission's authority in this area.

2 15 U.S.C. § 80b-2(a) (11). There is no universally accepted definition of the term "hedge fund." As the Commission staff noted in its September 2003 report on hedge funds, "the term generally is used to refer to an entity that holds a pool of securities and perhaps other assets, whose interests are not sold in a registered public offering and which is not registered as an investment company under the Investment Company Act." SEC Staff, Implications of the Growth of Hedge Funds 3 (2003).

3 15 U.S.C. § 80b-3(a).

4 15 U.S.C. § 80b-3(b)(3).

5 17 CFR 275.203(b)(3)-1(a)(2).

offering of interests in a limited partnership.[6] Hedge fund advisers generally rely on these provisions to avoid the Act's registration requirement.

II. Discussion

The Commission has extensive authority to adopt rules under the Act, as well as to repeal or modify exemptions by rule. Section 211(a) of the Act provides the Commission with broad general rulemaking authority "to make, issue, amend, and rescind such rules and regulations and such orders as are necessary or appropriate to the exercise of the functions and powers conferred upon the Commission elsewhere in this title."[7] The Supreme Court has explained that the validity of a rule promulgated under a broad grant of authority, such as the one in Section 211(a) of the Act, will be sustained as long as it is "reasonably related to the purposes of the enabling legislation."[8] There are also several specific provisions of the Act that may be relevant to rulemaking regarding hedge fund advisers.

Section 208(d) of the Act, for example, makes it "unlawful for any person indirectly, or through or by any other person, to do any act or thing which it would be unlawful for such person to do directly under the provisions of this title or any rule or regulation thereunder."[9] The statutory requirement to register does not apply to, among other persons, "any investment adviser who during the course of the preceding twelve months has had fewer than fifteen clients and who [does not hold] himself out generally to the public as an investment adviser...."[10]

Section 206 of the Act provides the Commission with broad authority to combat fraud by investment advisers.[11] Notably, Section 206(4) directs the Commission, by rules and regulations, to "define, and prescribe means reasonably designed to prevent" fraud by advisers.[12] Indeed, even in the absence of additional rulemaking, hedge fund advisers are subject to the prohibitions in Section 206 of the Act, as well as other antifraud provisions of the federal securities laws.

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6 17 CFR 275.203(b)(3)-1(c).

7 15 U.S.C. § 80b-11(a).

8 See Mourning v. Family Publications Service, Inc., 411 U.S. 356, 369 (1973), quoting Thorpe v. Housing Authority of the City of Durham, 393 U.S. 268, 280-81 (1969).

9 15 U.S.C § 80b-8(d).

10 15 U.S.C. § 80b-3(b)(3).

11 15 U.S.C. § 80b-6.

12 15 U.S.C. § 80b-6(4).

The Commission also has authority under other provisions of the Act to adopt rules that grant exemptions and make classifications,[13] as well as to modify those rules. Accordingly, it has the ability to revisit the existing exemptive and similar rules that many hedge fund advisers traditionally have relied upon to remain exempt from investment adviser registration. In addition to explicit statutory authority granted by provisions of the Advisers Act, the Supreme Court has recognized that regulatory agencies have authority to adopt rules to fill any gap left, implicitly or explicitly, by Congress.[14]

As in the case of any rulemaking, a definitive assessment of the Commission's authority requires consideration of the actual requirements contained in any proposed rule or rule amendment and the record developed during the rulemaking process. The Commission has not yet proposed a specific rule for comment nor, as a corollary, has any final administrative record yet been developed. Accordingly, consistent with past practice, the Commission can be expected to review the question of its authority at the time of final adoption of any rule relating to registration of hedge fund advisers.

III. Conclusion

The Investment Advisers Act of 1940 grants the Commission broad statutory authority, in appropriate circumstances, to adopt or amend regulations implementing the provisions of the Act. In proposing and adopting any rules regarding hedge fund advisers, the Commission would consider the extent to which the rules, in light of the administrative record, advance and conform to its statutory mandate under the Act and the federal securities laws more generally.

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13 Under these provisions, the Commission could consider tailoring any rules it adopts to the unique circumstances of hedge fund advisers.

14 See Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837, 843-44 (1984).

United States Senate

WASHINGTON, DC 20510

April 8, 2004

Honorable William Donaldson
Chairman
U.S. Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549

Re: "Amendments to Rules Governing Pricing of Mutual Funds," SEC Rel. No. IC-26288, File No. S7-27-03

Dear Chairman Donaldson,

We are writing to express our concern about the proposed rule referenced above published by the Securities and Exchange Commission ("SEC"). We understand the proposed rule is intended to prevent "late trading" of mutual funds, a goal we support in order to restore investor confidence in the U.S. securities markets. However, we are concerned that the proposed rule, if adopted, would create hardships for many investors, particularly those located in the Alaska, Pacific, Mountain, and Central Time Zones.

As you know, the vast majority of mutual fund investors do not purchase their shares directly from mutual funds. Instead, they invest in mutual funds through intermediaries including brokers, investment advisers, and employer retirement plans. Currently, they are able to place orders to buy or sell mutual funds much like orders to buy or sell stocks, until the major U.S. securities markets close at 4:00 p.m. Eastern time. This enables investors to engage with relative ease in such transactions as same-day exchanges of assets between different fund families and redemptions of funds to purchase individual stocks.

As we understand the proposed rule, it would prohibit intermediaries such as brokers and retirement plan administrators from receiving orders up to 4:00 p.m. Eastern time. They would have to establish earlier cut-off times for receipt of orders in order for their customers to receive same-day pricing on mutual fund transactions. We understand this could be as early as 2:00 p.m. Eastern time, which obviously means 11:00 a.m. on the West Coast. After 11:00 a.m., investors would not be able to use the proceeds from a sale of mutual funds to buy other securities that day. In practice, investors in the Western States would find it difficult if not impossible to engage in the kinds of transactions they now take for granted.

Mutual funds have been an important investment vehicle for American families and will continue to be so only if all investors are treated fairly. We support additional efforts by the SEC to protect mutual fund shareholders from late trading. At the same time, we must not make mutual funds a less attractive option for millions of mutual fund shareholders. We feel the SEC's proposal would have this effect, particularly in the Western States, and urge the Commission to consider fully all alternative options.

Sincerely,

Mike Crapo | Patty Murray

Wayne Allard | Ted Stevens

Pete Domenici | Jon Kyl

Michael B. Enzi

Cc: Honorable Paul Atkins
Honorable Roel Campos
Honorable Cynthia Glassman
Honorable Harvey Goldschmid